THE INTERNAL REVENUE CODE OF 1954

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-THIRD CONGRESS

SECOND SESSION

ON

H. R. 8300

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

PART 4

APRIL 22 AND 23, 1954

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THE INTERNAL REVENUE CODE OF 1954

THURSDAY, APRIL 22, 1954

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

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

Present: Senators Millikin, Butler, Williams, Flanders, and Frear.

Also present: Senator Smathers.

The CHAIRMAN. The meeting will come to order. Mr. Thomas L. Preston. Good morning, Mr. Preston. Make yourself comfortable and identify yourself to the reporter.

STATEMENT OF THOMAS L. PRESTON, GENERAL SOLICITOR, ASSOCIATION OF AMERICAN RAILROADS

Mr. PRESTON. Thank you, sir.

Mr. Chairman and members of the committee, my name is Thomas L. Preston. I am general solicitor of the Association of American Railroads, with headquarters at Washington, D. C.

I should say for the record that the Association of American Railroads is a voluntary, nonprofit organization of railroads which operate more than 95 percent of the road mileage of the United States and realize in excess of 95 percent of the total gross revenues of all the railroads of the country.

Now, Mr. Chairman, I have before me a prepared statement, which I shall find it impossible to follow in full and literally within the time limitation that is necessarily imposed in these hearings, and that statement refers to a number of supporting statements dealing with particular topics of special interest to the railroads.

If I may, I should like to ask that at the conclusion of my brief oral observations this covering statement, together with the supporting statements, be incorporated in full in the record.

The CHAIRMAN. We will be very glad to have the material for the record.

Mr. PRESTON. The reporter has been furnished with a full set of these.

I may say, Mr. Chairman, that those statements have been most painstakingly prepared by those in our industry who we think are best qualified to deal with the several subjects covered, and we do earnestly invite their careful consideration by the members of the committee and the staff, in connection with H. R. 8300.

Now I should like to say at the outset that we in the railroad industry are certainly not wanting in a full appreciation of the tremend-

ous effort and study which has gone into the preparation of H. R. 8300. The very proportions of the bill testify to the efforts and the concentration which must have been devoted to that subject and, indeed, the matter was before the Ways and Means Committee through extended hearings in the course of last summer.

I would point out that in the course of those hearings there were indicated in advance a number of topics—I believe 40 in number—as to which testimony might be adduced, the indication being that those topics would, in all likelihood, be considered in connection with the revision bill. And, as to those topics which we were particularly concerned with, we then had our say.

However, upon the release of H. R. 8300, as reported by the Ways and Means Committee and passed by the House, we found that many provisions of urgent concern to the railroads are included in that bill as to which there was no forewarning whatever and with respect to which we had no opportunity in advance to express ourselves.

So, at the outset, if I may, I should like to refer to certain of those provisions which may perhaps be appropriately referred to as surprise provisions in this bill.

The CHAIRMAN. What is that?

Mr. PRESTON. Surplus provisions in this bill, of particular concern to the railroads.

First among them I would take up, if I may, the impact upon the railroad industry of section 275 of H. R. 8300 which, read in conjunction with section 312 of the bill, would have the effect of preventing the deduction for tax purposes of interest upon the familiar security known as the income or contingent interest bond. This is a matter of the most urgent importance to us, and we are convinced that the result cannot have been intended.

These bonds, as I shall undertake to show in as few words as I may, represent true indebtedness and partake in no sense of the character of an equity interest in the property. Yet, by legislative mandate H. R. 8300, for tax purposes, would convert these purely debt obligations into equity obligations and deprive the taxpayer of the deduction for interest paid thereon.

The CHAIRMAN. Just a minute, please. What was the theory of the committee on that?

Mr. SMITH. Senator, we have had this problem come up and there was no intention, where it was a true debt, to disallow the interest deduction, and it has affected the railroads and we are looking into it.

Mr. PRESTON. I might say, Mr. Chairman, that this matter has been taken up already with Mr. Stam and the gentlemen of his staff. I am confident that they have a complete grasp of the problem which confronts the railroads in connection with it.

These so-called income bonds may be briefly described in this way: They represent a fixed obligation to pay a sum certain in money on a fixed date. In that respect, they have no relation to anything in the nature of an equity security. Interest payable upon those obligations is in varying degree contingent upon the realization of earnings available for the payment of the interest. In many instances, the interest on those bonds, even though not earned, becomes fully payable as an absolute obligation upon the maturity of the bond. In many instances, a large portion of the interest is payable irrespective

of the realization of earnings, and only a fraction of the interest is dependent upon the realization of earnings.

The holders of the bonds have no voice in management. The interests, if earned—and I specially emphasize this point—the interest, if earned, is payable as a mandatory obligation, without any discretion in management, in contradistinction to anything in the nature of a dividend upon preferred stock, as to which the management may or may not declare a dividend, irrespective of the realization of earnings.

So we say here you have plainly a true debt obligation and, as has been indicated by the staff member who spoke just now, it was evidently not the intention to reach securities of that kind, and so we asked rectification.

In seeking to learn the purpose of H. R. 8300, with reference to these provisions in 275 and 312, we take it that the attempt was to reach what really would amount to a dividend, masquerading under the nomenclature of interest, upon what really is equity security, spuriously denominated a bond.

Now, there is nothing of that kind in the railroad industry, and we say that if there be an evil there, the law should be cut to fit the evil and by no means permitted to overshoot the mark and reach this great mass of perfectly legitimate securities, which are outstanding in the railroad industry to the tune of in excess of $1 billion, carrying annual interest charges in the neighborhood of $42 million.

Now, that is a very serious matter. We confidently look forward to its correction if this bill is to be reported. Section 275 should be stricken from the bill.

The CHAIRMAN. I may say that I am not prejudging anything here, but it seems to me that as far as we go with it, the staff has told me and others have told me, and it seems there is some kind of an inequity that should be corrected.

Mr. PRESTON. I am glad to hear you say that, Mr. Chairman, because we think that the case is abundantly clear, and the injustice which would be effected by the bill, if uncorrected in that regard, is a very serious one, and particularly so in our important railroad industry.

The CHAIRMAN. These bonds have no voting privilege?

Mr. PRESTON. No, sir; no voting privilege. No voice in management, and none of the characteristics of an equity security. It is a pure debt obligation. And the only distinction between these bonds and fixed-interest bonds of the ordinary character——

The CHAIRMAN. What kind of bond did you say?

Mr. PRESTON. The only distinction between thees bonds and the ordinary fixed-interest bond is that in the case of these bonds, in varying degree, the annual interest is payable in the event of the realization of earnings out of which it is paid.

I should add the great bulk of these bonds outstanding in the railroad industry have been issued as part and parcel of reorganization plans approved over the course of the last 15 years in railroad reorganizations, with the approval of the Interstate Commerce Commisssion and the courts.

The CHAIRMAN. Well, I think that you can feel reasonably comfortable at the present time. There are many slips between the cup and the lip in this business, but you may have something.

Mr. PRESTON. Mr. Chairman, you make me happy, and I trust that the slip will not occur.

Now, I must put my words very close together, Mr. Chairman. I should like to mention, next, the provisions of section 305 and 306 of H. R. 8300, which treat of securities issued in the discharge of preferred dividends in arrears and arrearages of interest.

As we understand the incidence of those sections, they would require, among other things, that in railroad reorganizations, approved by the Interstate Commerce Commission and the courts, securities assigned to preferred stock or bonds, and unrealized dividends or interest thereon shall, to the extent attributable to arrearages in dividends or interest, be treated as taxable income.

The impact of these provisions is set out in the written papers which support the general statement to which I have referred.

It must suffice at the moment to say that the effect of these two sections, as incorporated in the bill, would be to hamper and, we think would often prevent, the necessary assent of security holders to reorganization plans, which would be recognized by the Commission and the courts as in the public interest.

We believe these provisions to be unwise and unsound and we urge their elimination from the bill. I cannot go further into that, but must pass immediately to section 309 of the bill, which imposes a prohibitive 85 percent penalty tax upon the corporation which redeems its preferred stock, income bonds, or debentures within a period of 10 years subsequent to their issue or within a period of 10 years following January 1, 1954, whichever is later.

We are quite at a loss to understand why it should be regarded, as apparently this bill does regard it, that the reduction of outstanding railroad obligations through redemption of outstanding securities is not in the public interest and involves a transaction to be regarded penalized in the prohibitive amount of 85 percent upon the consideration paid in redemption of the stock.

The CHAIRMAN. What was the House theory on that?

Mr. SMITH. This section has been brought up by a number of witnesses, and we are going to bring it to the attention of the committee.

The CHAIRMAN. We will give it very careful consideration.

Mr. PRESTON. Thank you, Mr. Chairman.

We understand that the evil sought to be reached there is the preferred stock bailout, so-called, which is possible perhaps in the case of closely held corporations, but which is nonexistent in the railroad industry. And we ask that if this section is to be retained——

The CHAIRMAN. Let me ask, is there any railroad company that is a closely held corporation? I am talking about operating companies?

Mr. PRESTON. No, Mr. Chairman. The railroads are typically and universally widely held by large numbers of stockholders and there is not in the railroad industry anything similar to family-held or closely group held corporations where, through a finagling of their securities, they might avoid an income tax through this device known as the preferred stock bailout.

So we say if the provision is to be retained, it should certainly be fashioned to meet the evil at which it was aimed and not to reach beyond that and discourage and prevent reorganization plans which would otherwise meet the test of the public interest.

Now, I only mention in a word, Mr. Chairman, section 461 of the bill, having to do with the accrual of real property taxes. That is a matter with respect to which I shall rely entirely upon our written statement. There is grave apprehension that in the year of transition from the prevailing practice under existing law to the proposed practice—and we think it is an improved practice under the proposed bill—there will be a loss of 1 year's deduction on account of real estate taxes accrued or paid. Now, I can't go further on that.

Another matter which was new to us when the bill came out is the matter of a provision, as we understand it, that contributions to capital by a nonshareholder shall take, for the purposes of depreciation—and I believe other purposes as well—a basis of zero. On that score, I should like to be permitted, if I may, to rely upon the written statement, because I wish to mention specifically other matters and I believe I am getting close to my time.

The same is true as to the pay-as-you-go provisions in H. R. 8300, relating to the declaration and payment of estimated income taxes by corporations. We apprehend great difficulty with respect to those provisions. Those apprehensions are set forth in our statement, and we invite the attention of your committee and the staff to what is there said on that score.

Now, I want to refer to some matters which were not altogether unexpected, having been included in the program which the Ways and Means Committee announced for its hearings last year. The matter of the corporate tax rate is, of course, of great concern to the railroads in common with all other corporate taxpayers in the country. Confronted with a tax rate which takes more than one-half of net income, the railroads are gravely perturbed and would protest the extension of a rate so high as 52 percent, even for 1 year, if by any possible means the absolute revenue requirements of the Government can be made to fit with a more generous treatment of the taxpayer in that regard. The railroads, of course, are subject to public regulation with regard to their charges and many phases of their operations and, as I will point out in another connection, if I may, they have the benefit only of an extraordinarily low depreciation charge. They are, therefore, in a sense squeezed between an upper and a lower millstone and the continuation of a rate as high as 52 percent is an extraordinarily burdensome imposition, peculiarly with respect to our industry.

Now, on the matter of depreciation, we offered before the Ways and Means Committee a suggestion for optional depreciation charges within the range of zero to 20 percent, and I understand I am not to go into that, since it was fully developed in the course of those hearings. But H. R. 8300 incorporates what is referred to as the declining-balance method of depreciation. Now, that declining-balance method, if I understand it correctly, amounts to this: The taxpayer may double the straight-line depreciation rate and apply it in a fashion which will result in recovery of two-thirds of the cost of the property in the first half of its estimated useful life.

Now, it is easy to see that a provision of that kind would be of great benefit, Mr. Chairman, to industries which depend in the nature of their business upon preponderantly short-lived property. To double a depreciation rate of, say, 10 percent and come up with 20 percent,

and apply it by this method, would be a substantial relief, and would be calculated to offer an inducement to the investment of new capital in the improvement of the plant of such industries.

The railroad industry, on the other hand, typifies those industries which, in the nature of their business, depend preponderantly upon very long-lived property, with the result that the average depreciation rate in the case of railroads is only 3 percent. Now, to double 3 percent and come up with 6 percent is a very mild measure of relief indeed. So mild that in our view it will not substantially tend to encourage the investment of capital in the railroad plant, which we take to be the end objective of this proposed revision.

So, with respect to the declining-balance method, if it is to be retained in the bill, we urge upon the committee that at least a provision be incorporated that, for the purpose of the application of that method, the estimated service life of depreciable assets shall in no case be taken as in excess of 20 years.

Differently stated, that would mean that for the purpose of this declining-balance depreciation calculation, the minimum straight-line rate would be 5 percent; doubled it would be 10 percent. And with that provision we think there might be a chance of some degree of measurable benefit to the railroad industry. That is a very modest request, we think, and we urge your favorable consideration of it.

The CHAIRMAN. We will give it careful consideration.

Mr. PRESTON. Now, I come to the matter, next, of consolidated returns. Of course, the conspicuous feature in connection with consolidated returns is the long-standing and long-protested imposition of a 2-percent penalty upon the privilege of filing consolidated returns. In other words, the 52-percent rate, which in all conscience is high enough, becomes 54 percent, in the filing of a consolidated return.

Now, we presented our case with respect to that matter before the Ways and Means Committee, and it is fully set forth with one of the supporting papers which I submit here.

We continue to urge the elimination of that penalty as contrary to the public interest. But, in connection with consolidated returns, there is another feature which I would call attention to, which is new in H. R. 8300. That is the remedial provision which would reduce from 95 percent to 80 percent the stock ownership requirement necessary to the filing of consolidated returns.

Now, we welcome that liberalization and think it would be a good thing. We should like, however, if the committee should regard it as appropriate—and we believe it would be appropriate—to have H. R. 8300 amended in that respect so as to provide that in cases of stock ownership ranging between 80 percent and 95 percent, the inclusion of corporations in a consolidated return shall be optional and not mandatory. We explain why, in the absence of such a modification, this would in some instances, result in an injustice to minority stockholders in corporations, in certain corporate setups.

I shall take only a moment—and I am trespassing on your time too much, I fear.

The CHAIRMAN. Go ahead. I am sorry about the limitation of time, but it is just a physical impossibility to do what we have to do here without imposing on you. It is very embarrassing to this committee.

Mr. PRESTON. Mr. Chairman, we fully appreciate the exigencies of the situation and the restriction in point of time.

I only mention section 108 (b) of the bill, which extends section 22 (b) (10) of the present law for a period of 1 year. That is the provision of present law which excludes from gross income the so-called gain resulting from recapitalization in the process of reorganization. It has been in effect and has been available and taken advantage of by a large number of corporations which have already come out of reorganization. In all fairness, it should continue to be available to those several corporations still in reorganization. We think it should be a permanent feature of the code, but we ask that at least it be continued for a period of 3 years rather than for only 1 year.

Now, I come to a matter which is of outstanding importance, Mr. Chairman, to a considerable number of the most important railroads in the country, and that is the treatment, both under existing law and under the proposed bill, of the net operating loss deduction and the dividends received credit.

The existing code provides for deduction from gross income of a net operating loss which may be carried backward or forward within a span of 7 years, and H. R. 8300 would increase that span to 8 years. The purpose is to spread the loss and attain a measure of equality as between corporations with a steady annual taxable income, on the one hand, and corporations with fluctuating gain and loss years, on the other hand, but realizing overall the same aggregate taxable net income.

Now, the existing code permits a corporate taxpayer to take credit against net income of 85 percent of intercorporate dividends, and this is to ameliorate the double taxation of intercorporate earnings. In effect, the provisions of H. R. 8300 would permit the same thing, but this credit, this dividend received credit, denominated a deduction in H. R. 8300, is so treated under existing law—and in substantial degree under the new bill—as to defeat the purposes of both the net loss carryover provision and the dividends received provision. A taxpayer with fluctuating years of gain and loss over the prescribed period may, under existing law and under H. R. 8300 as well, be subjected to much higher taxes upon the same aggregate income than a taxpayer realizing a steady annual gain.

The unjust result is clear enough. The technical provisions which bring it about are, it is true, involved. We have attempted to spell out all this with clarity in the paper which I shall ask leave to file, dealing with the subject. H. R. 8300, I should say, takes a short step in the right direction towards amelioration of this result, but the step is altogether too short and further revision of the existing code is required if the anomaly to which I have referred is to be prevented.

Now, I shall not take more of your time, except to mention that among the papers which I have not yet referred to is one dealing with carryovers in certain corporate acquisitions, and I ask leave to file, if I may, seriatim, following the incorporation of my prepared statement, a series of papers which are listed at the conclusion of my overall statement, Mr. Chairman, and I shall not take the time here to read that list.

The CHAIRMAN. We will put them in the record.

Mr. PRESTON. I thank you very much for your patience and attention.

The CHAIRMAN. Thank you.

(The statements of Mr. Preston follow:)

STATEMENT OF THOMAS L. PRESTON, GENERAL SOLICITOR OF THE ASSOCIATION OF AMERICAN RAILROADS, RELATIVE TO H. R. 8300, THE INTERNAL REVENUE CODE OF 1954

Mr. Chairman and gentlemen of the committee, my name is Thomas L. Preston. I am general solicitor of the Association of American Railroads with headquarters at Washington, D. C. The Association of American Railroads is a voluntary, nonprofit organization of railroads which operate more than 95 percent of the road mileage in the United States and realize in excess of 95 percent of the total gross revenues of the railroads in this country.

Let me say at the outset that we in the railroad industry are not wanting in appreciation of the prodigious effort looking to an overall revision of the Internal Revenue Code which is embodied in H. R. 8300. The committee, on the other hand, will appreciate, I am sure, that taxpayers affected by the manifold and intricate provisions of the bill have been at a serious disadvantage in fully appraising its effect, by reason of its very magnitude and the time limitation necessarily involved if the measure is to be acted upon at this session of Congress.

It is true that hearings were held during the summer of last year with respect to a number of designated features of the tax laws which, it was indicated, would be under advisement in the formulation of the code revision bill, and as to a number of those topics of particular interest to the railroads we appeared and presented our views.

It is also true, as we find upon examination, that H. R. 8300 deals with matters of the most serious import to the railroad industry of which we had no forewarning and in respect of which our views can therefore not have been taken into consideration. We are by no means sure that we have as yet discovered all the features of the bill which would in peculiar degree affect our industry. But already we find a number which we earnestly urge upon the attention of the committee for further revision or complete elimination.

We understand that oral presentation to your committee must not be repetitious of what was heretofore presented to the Ways and Means Committee, but that full presentation may be made to your committee in the form of written statements. I shall therefore ask leave, at the conclusion of my brief observations, to file a number of written statements dealing with matters of important concern to us. I shall scarcely be able in the time at my disposal to make more than thumbnail reference to some of them. I hope this will not be taken to minimize the importance of those topics upon which I will find it impossible to dwell in my oral presentation.

Disallowance of deduction of interest on income bonds (secs. 275 and 312 of the bill).—Conspicuous among the surprise features of the bill of great moment to the railroad industry is the disallowance, by section 275 (in conjunction with sec. 312), of deduction of bond interest, payment of which is in whole or in part contingent upon earnings. The familiar income, or contingent interest, bond has long been a standard security in railroad financing. These bonds are strictly debt obligations and disallowance of deduction of interest paid upon them would have a disastrous effect upon railroad financing.

Attached to the written statement which I will ask leave to file on this topic is a table showing the issues of contingent interest bonds by class I railroads outstanding as of December 31, 1952, whereon there are indicated the significant features of these bond issues. Bonds of this type constitute an absolute obligation to pay a sum certain in money at a fixed maturity date. For the most part, they are mortgage securities. Interest on these bonds, while contingent in varying degree upon earnings, must be paid if earned, beyond any discretion in management. This is in striking contrast to dividends upon preferred stock, which are payable only in the discretion of management, without regard to earnings. Bonds of this character are outstanding in the railroad industry in an aggregate face amount of about $1 billion, carrying annual interest charges amounting to about $42 million.

Some of these bonds were issued more than 50 years ago and others were issued during the decade of the twenties, but the great bulk of them were issued during the last 15 years in reorganizations and readjustments of capital structure effected under the jurisdiction of the Interstate Commerce Commission and the courts. Disallowance of deduction of interest on bonds of this character would dislocate reorganization plans already fully consumated with court and Commission approval; as to outstanding issues it would effect a radical

change in the character of the security; and as to future issues, it would cut off from the railroad industry an important market for its securities. These results would clearly be contrary to sound principles of taxation (as treating interest paid upon indebtedness as though it were in fact a dividend) and would materially weaken the financial situation of the railroads, thus running counter to the public interest. It is submitted that section 275 of H. R. 8300 should be eliminated from the proposed bill.

The report of the Committee on Ways and Means declares, at page A99, that the intent of the revision is to confine the term "securities," interest on which will be deductible, to "bona fide debts only." Presumably, then, the objective of this proposed revision is to reach dividends masquerading as interest upon spurious "bonds" which are in reality preferred stock. It should be observed in this connection that under existing law dividends disguised as interest are nondeductible and that the courts have been at pains to distinguish debt obligations from equity interests, judging the matter upon the realities of particular situations. Apparently the proponents of the bill would substitute a statutory rule for the judgment of the courts. But in attempting this, H. R. 8300 overshoots the mark and would treat as "nonparticipating stock" securities which indubitably represent "bona fide debts only."

The wisdom of attempting a codification of the line of demarcation between bona fide debt, on the one hand, and an equity interest, on the other hand, is open to serious question. Varying considerations enter the equation in particular cases, and it may well be the part of wisdom to leave the law as it stands and continue to rely upon the judgment of the courts in the premises. The whole question requires deliberate consideration after full public hearing where the views of those affected may be expresesd and debated.

Accordingly, the view is urged upon the committee that retention in the bill of section 275 would be hasty and ill-advised. There is no occasion for haste in this regard and serious injury and injustice are inevitable if the section be retained. Elimination of section 275 offers the ready solution. If this not be done, then certainly section 312 of the bill should be modified so as to exclude from the classification of nonparticipating stock contingent interest bonds which represent true indebtedness.

Treatment of securities issued in discharge of preferred dividends in arrears (sec. 305) or in satisfaction of arrearages of interest (sec. 306).—As we understand the incidence of sections 305 and 306 of the proposed code, they would require, among other things, that in railroad reorganizations, approved by the Interstate Commerce Commission and the courts, securities assigned to preferred stock or bonds, and unrealized dividends or interest thereon shall, to the extent attributable to arrearages in dividends or interest be treated as taxable income. The impact of these provisions is set out in the written papers which I shall ask leave to file. It must suffice at the moment to say that the effect of these two sections, as incorporated in the bill, would be to hamper and, we think often prevent, the necessary assent of security holders to reorganization and recapitalization plans which meet the approval of the Interstate Commerce Commission and the courts as in the public interest. The levying of an income tax upon the issuance of stock in discharge of preferred stock dividends or bond interest in arrears ought, we think, to be eliminated from the bill.

Generally, these distributions are in respect of dividends and interest which could never be paid by the corporations as initially organized. It would be unrealistic, and we think unwise, to impose an income tax under such circumstances. The tax would rest upon a fiction, not a reality, of income received In reality it would amount to a capital levy. And it would discourage, if not prevent, recapitalizations in the public interest.

The 85-percent penalty tax on redemption of preferred stock, income bonds, and debentures; section 309 of H. R. 8300.—Section 309 of H. R. 8300 presents another innovation of which there was no forewarning. It would impose a prohibitive tax (85 percent) upon the value of securities or property paid out in redemption of nonparticipating stock, within 10 years of the date of issuance, or within 10 years of January 1, 1954, whichever date is later. We are at a loss to understand why it should be regarded as a salutary provision to prevent the reduction of capital liabilities through acquisition by the issuing corporation of its outstanding obligations. Indeed, in the railroad field, this has been understood to be approved as in the interest of sounder financial structure. In railroad reorganizations, the Interstate Commerce Commission has usually provided for a mandatory sinking fund contemplating the redemption of securities in advance of maturity. The bill, in these circumstances, would impose a penalty tax of 85 percent upon mandatory redemption.

Our understanding is that the evil intended to be reached by section 309 is the so-called preferred stock bail-out. Apparently this involves the issuance of preferred stock as a dividend on common stock, followed by a redemption of the preferred stock for cash. Thus, the stockholder may enjoy a cash distribution without being subjected to tax thereon as a dividend.

We do not know whether this has been a common practice among corporations whose stock is closely held, but certainly there has been little, if any, of it among publicly held corporations and, so far as we know, none of it among railroad corporations. The proposal embodied in H. R. 8300 presents a serious problem in the railroad industry. The evil aimed at appears to be nonexistent there. We urge, therefore, that section 309 be deleted from the bill, or at the least so revised as to apply only to the evil intended to be cured, apparently the preferred stock bail-out practice among closely held corporations.

Accrual of real property taxes; section 461.—This is a technical matter upon which I shall rely upon our written statement. It appears that technical correction is needed to prevent serious injustice from the loss of deduction of accruals in the year of transition from the existing practice to that provided for in the revised code.

Contributions to capital by nonshareholders; section 355 (c).—Section 355 (c) of the bill would, if enacted in its present form, cause hardship to railroad companies in connection with improvement projects to which nonshareholders, including Federal, State, county, or municipal governments, have contributed a part of the cost.

Typical of such projects is the grade-crossing elimination, involving the construction of underpasses and overpasses. Another example is the installation of automatic signals at grade crossings. Still another is the relocation of a line of railroad incident to flood-control projects, and there are many others.

In these various situations the nonshareholder contributes all or part of the cost of the new facilities and the railroad company is in general responsible for maintenance, replacement, and renewal of the facilities.

In its present form section 355 (c) would prevent the railroad company from deducting depreciation on this donated property, for it provides that the basis of property contributed by a nonshareholder shall be zero. Consequently, section 355 (c) would prevent the railroad company from building up during the lifetime of the property a fund for its ultimate replacement, despite the fact that the railroad company is obligated to replace and renew the property. This result is not justified and would impose an undue hardship upon the railroads. We, therefore, urge that section 355 (c) be eliminated from H. R. 8300.

"Pay as you go" tax payments by corporations.—We urge the elimination of the provisions of H. R. 8300 relating to the declaration and payment of estimated income taxes by corporations. Under these provisions railroad corporations would be subjected to great risk of severe penalty by reason of their inability to reckon with accuracy the effect of coming events upon their meager and highly sensitive income. Furthermore, there is lacking any provision for quick refund in the event of overpayment. The subject is dealt with in detail in the paper I shall ask leave to file.

I come now to matters which were not altogether unexpected.

Corporate tax rate.—This bill would continue in effect for another year the extraordinarily high corporate tax rate of 52 percent, and we join with others who protest. The railroad industry is particularly hard hit. Its charges for the services it has to offer are held down by public regulation. On the other hand, the depreciation charges allowed in the computation of taxable income are extraordinarily low in the railroad industry. The railroads are thus caught between the upper millstone of exorbitantly high tax impositions on governmentally restricted income, upon the one hand, and extraordinarily low allowable charges for depreciation, on the other hand. The situation of the railroads is such as to lend emphasis to the overriding burden of a tax rate which takes away more than one-half of net income. Your committee is urged to examine this matter with an eye to fixing the lowest rate commensurate with absolute revenue requirements.

Depreciation.—The treatment of depreciation in H. R. 8300 is a matter of profound importance to the railroad industry. I am able now to give it only passing mention, and must rely upon the written statement which I shall ask leave to file. Section 167 of the bill would permit charging depreciation on the declining balance method at double the straight-line rate. Application of this provision would result in a chargeoff of twice the existing straight-line rate in the first year following acquisition and a recovery of 66⅔ percent of cost in the first half of

the estimated useful life of the property. This method of accounting for depreciation will afford material benefit to industries utilizing preponderantly short-lived property, but it will be of little assistance to industries such as the railroad industry which in the nature of things utilizes preponderantly long-lived property. The average depreciation rate in the railroad industry is only 3 percent. We urge in connection with the proposed declining balance method of depreciation that it be provided that the estimated life of depreciable assets shall in no case be taken to be in excess of 20 years. This would provide a minimum straight-line rate of 5 percent and a declining balance rate of 10 percent and thus offer some prospect of inducement to capital investment in an improved railroad plant.

Consolidated returns; reduction of the requirement of stock ownership from 95 percent to 80 percent in relation to the 2 percent penalty.—Section 1502 of H. R. 8300 provides for reduction from 95 percent to 80 percent of the stock ownership requirements for the filing of consolidated returns. This is a welcome liberalization. However, considered in connection with the 2-percent penalty for filing consolidated returns, which the bill retains, it requires modification if undue hardship is to be avoided with respect to substantial minority interests ranging up to 20 percent of total ownership. Our suggestion, in a word, is that so long as the 2-percent penalty is retained, the inclusion in consolidated returns of companies whose stock is owned more than 80 percent and less than 95 percent be made optional and not mandatory.

Income from discharge of indebtedness in railroad receivership and bankruptcy reorganizations; section 108 (b) of H. R. 8300.—Section 108 (b) of H. R. 8300 would extend to December 31, 1955, the provisions of section 22 (b) (10) of the present code, which would otherwise expire at the end of the current year. This section excludes from the gross income of a railroad corporation the amount of any income attributable to the discharge of its indebtedness pursuant to a court order in a receivership proceeding or in a proceeding under the Bankruptcy Act. This provision, by virtue of repeated extensions has been a part of the code since 1942. Its extension for 1 year is welcome, but in our view inadequate. We urge its incorporation as a permanent feature of the code, or at least its extension for a period of 3 years. This appears necessary in order to avoid unjustified discrimination as between railroads which have come out of reorganization and had the benefit of the section and railroads which are still in the process of reorganization. The subject is elaborated in a written statement which I shall ask leave to file.

The net operating loss deduction and the dividends received credit.—The existing code provides for deduction from gross income of a net operating loss which may be carried backward or forward within a span of 7 years (under H. R. 8300, 8 years). The purpose is to spread the loss and attain a measure of equality as between corporations with a steady annual taxable income, on the one hand, and corporations with fluctuating gain and loss years, on the other hand.

The existing code permits a corporate taxpayer to take credit against net income of 85 percent of intercorporate dividends, in order to ameliorate the double taxation of intercorporate earnings. In effect, the provisions of H. R. 8300 permit the same thing. But this credit is so treated under existing law—and in substantial degree similarly treated in H. R. 8300—as to defeat the purposes of both the net-loss-carryover provision and the dividends received credit provision. A taxpayer with fluctuating years of gain and loss over the prescribed period may, under existing law, and under H. R. 8300 as well, be subjected to much higher taxes upon the same aggregate net income than a taxpayer realizing a steady annual gain.

The unjust result is clear enough. The technical provisions which bring it about are involved. We have attempted to spell it all out in the paper I shall ask leave to file dealing with this subject. H. R. 8300 takes a short step in the right direction. But in substantial measure the evil would remain.

Carryovers in certain corporate acquisitions.—Section 381 of H. R. 8300, entitled "Carryovers in Certain Corporate Acquisitions," eliminates certain inequities where under existing law a successor corporation is not allowed to stand in the shoes of its predecessor with respect to deductions, credits, and other allowances. However, section 391 of H. R. 8300 provides that the right to carry over these tax benefits to an acquiring corporation in a tax-free reorganization shall be effective only with respect to distributions or transfers occurring after March 1, 1954. For reasons set forth in the paper I shall ask leave to file on this subject, we urge that in order to avoid inequity, section 391 be modified so that the carryovers specified in section 381 will be allowed in all open tax years or alternatively, in all tax years ending after March 1, 1954, without regard to when the transfer or distribution occurred.

Conclusion.—In conclusion, I ask leave to file for the record and the consideration of your committee and its staff written statements dealing with the following topics:

Disallowance of Deduction of Interest on Income Bonds (secs. 275 and 312 of the bill).
Stock Issued in Discharge of Preferred Dividends in Arrears (sec. 305 of the bill).
Distribution of Securities under Section 306.
Eighty-five Percent Penalty Tax on Redemption of Preferred Stock, Income Bonds, and Debentures (sec. 309 of the bill).
Accrual of Real Property Taxes (sec. 461 of the bill).
"Pay as You Go" Tax Payments by Corporations (sec. 6016 of the bill).
Depreciation (sec. 167 of the bill).
Consolidated Returns: Elimination of 2 Percent Penalty on Filing Consolidated Returns; Optional Use of Consolidated Returns Where There Is 80 Percent to 95 Percent Stock Ownership; and Inclusion of Lessor Companies in Consolidated Returns.
Income From Discharge of Indebtedness in Railroad Receivership and Bankruptcy Reorganizations (secs. 108 (b) and 1017 of the bill).
The Net Operating Loss Deduction and the Dividends Received Credit (secs. 172 (d) (5) and 246 (b) of the bill).
Carryovers in Certain Corporate Acquisitions (secs. 381 and 391 of the bill).

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON DISALLOWANCE OF DEDUCTION OF INTEREST ON INCOME BONDS

Sections 275 and 312 of H. R. 8300 would disallow deduction of bond interest payment of which is contingent upon earnings. In other words, deduction of interest paid upon the familiar income, or contingent interest, bond would be disallowed. For tax purposes, a true debt obligation would thus be treated as an equity security and interest paid thereon would be treated as a dividend.

The disallowance of deduction of interest of bonds of this character would be disastrous to the railroad industry. It would dislocate reorganization plans already fully consummated with court and Commission approval; as to outstanding issues it would effect a radical change in the character of the security; and as to future issues, it would cut off from the railroad industry an important market for its securities. These results would clearly be contrary to sound principles of taxation (as treating interest paid upon indebtedness as though it were in fact a dividend) and would materially weaken the financial situation of the railroads, thus running counter to the public interest. It is submitted that section 275 of H. R. 8300 should be eliminated from the proposed bill.

Attached hereto is a table showing the issues of contingent interest bonds outstanding as of December 31, 1952, by class I railroads whereon the principal features of the bonds are shown in summary fashion. They constitute a definite obligation to pay a sum certain in money at a fixed maturity date. Interest, if earned, must be paid, in striking contrast to dividends, which are payable or not in the discretion of management. In most instances, income bonds issued by railroads are secured by a general mortgage on the property. In other cases they are secured by collateral. They occupy a position not only superior to that of the holder of all capital stock outstanding, but in practically all instances a position superior to that of general creditors.

In many instances only a portion of the interest is contingent upon earnings and, characteristically, all or a stated portion of unearned interest is made cumulative and payable in any event upon maturity of the bond. Some of these bonds were issued more than 50 years ago and others were issued during the decade of the twenties, but the great bulk of such bonds were issued during the last 15 years in reorganizations and readjustments of capital structure effected under the provisions of the Interstate Commerce Act, the Bankruptcy Act, or in equity receiverships, all under the jurisdiction of the Interstate Commerce Commission and the courts.

The report of the Committee on Ways and Means declares, at page A99, that the intent of the revision is to confine the term "securities," interest on which will be deductible, to "bona fide debts only." Presumably, then, the objective of this proposed revision is to reach dividends masquerading as interest upon spurious "bonds" which are in reality preferred stock. It should be observed in this connection that under existing law dividends disguised as interest are non-

deductible and that the courts have been at pains to distinguish debt obligations from equity interests, judging the matter upon the realities of particular situations. *John Kelley* v. *C. I. R.* and *Talbot Mills* v. *C. I. R.*, heard together and decided by the Supreme Court in one opinion (326 U. S. 521 (1946)). Apparently the proponents of the bill would substitute a statutory rule for the judgment of the courts. But in attempting this, H. R. 8300 overshoots the mark and would treat as "nonparticipating stock" securities which indubitably represent "bona fide debts only."

Railroad income bonds represent true debt and have none of the characteristics of capital stock. They have, in most instances, been issued in replacement of fixed interest debt, where the railroad company's prior experience indicated the necessity for reduction of fixed charges. There has never been any question about the deductibility of interest on these bonds in computing taxable income. Consequently, it is shocking to find that in the proposed bill these bonds are characterized not as debt but as "nonparticipating stock" and that none of the interest paid thereon would be allowed as a deduction in computing net taxable income. Holders of these bonds are creditors of the obligor, not owners of an equity interest in the issuing corporation.

The striking difference between income bonds, the interest on which is deductible under present law, and preferred stock, the dividends on which are not deductible, is indicated by a comparison of the market values of such bonds and stock. For example, the convertible income 4½-percent bonds of the Baltimore & Ohio Railroad Co. closed at 69⅛ on April 9, 1954, in comparison with 43 for its 4-percent preferred stock. The general mortgage 4½-percent income bonds of the Milwaukee Road, Series A, sold at 70¾, in comparison with 38 for its 5-percent preferred stock. The St. Louis-San Francisco Railway income mortgage 4½-percent bonds sold at 88, in comparison with 66¼ for its 5-percent preferred stock. It is to be noted that these bonds are not only quoted on the New York Stock Exchange, but they are also widely held.

The relatively higher prices for these bonds reflect the higher character of the security. Where earnings are insufficient to pay both the interest on the income bonds and the dividends on the preferred stock, the interest on the bonds is first paid. Furthermore, even though there may be earnings on the preferred stock, it is payable only in the discretion of the board of directors, whereas the interest on the bonds is mandatorily payable if earned. Earnings are determined under rules prescribed by the Interstate Commerce Commission. There could be no clearer evidence of the difference in the true character of these two classes of securities than the disparity in their prices in the public market; yet this bill as it passed the House would dump them into the same basket and forbid the interest deduction as though it were a dividend on preferred stock.

As already pointed out, to take away the deduction of interest paid upon these bonds would dislocate and disrupt many reorganization plans already consummated; would disregard the circumstance that the railroads are subject to public regulation and that their security issues require prior approval of the Interstate Commerce Commission; and would artificially convert interest paid upon debt, into dividends for tax purposes without any justification whatever.

It should be emphasized that the revision under discussion was not the subject of hearing before the Ways and Means Committee of the House. It came as a complete surprise to those vitally affected. The conclusion is inescapable that its implications were not fully realized.

At all events, it is clear that the wisdom of attempting a codification of the line of demarcation between bona fide debt, on the one hand, and an equity interest, on the other hand, is open to serious question. Varying considerations enter the equation in particular cases, and it may well be the part of wisdom to leave the law as it stands and continue to rely upon the judgment of the courts in the premises. The whole question requires deliberate consideration after full public hearing where the views of those affected may be expressed and debated.

Accordingly, the view is urged upon the committee that retention in the bill of section 275 would be hasty and ill-advised. There is no occasion for haste in this regard and serious injury and injustice is anticipated if the section be retained. Elimination of section 275 offers the ready solution. If this not be done, then certainly section 312 of the bill should be modified so as to exclude from the classification of nonparticipating stock contingent interest bonds which represent true indebtedness.

Contingent interest bonds issued by railways of class I in the United States and outstanding as of Dec. 31, 1952

ISSUED IN BANKRUPTCY OR RECEIVERSHIP PROCEEDINGS

Railroad and security	Date issued	Date due	Amount outstanding	Interest rate: Fixed	Interest rate: Contingent	Annual interest	Percent contingent interest cumulative
				Percent	*Percent*		
Atchison, Topeka & Santa Fe: Adjustment mortgage bonds	Dec. 12, 1895	July 1, 1995	$48,622,500		4	$1,944,900	All after July 1, 1900.
Baltimore & Ohio:							
1st mortgage bonds, series B	Dec. 1, 1947	July 1, 1975	64,508,500	4	1	3,225,425	All
Refunding and general mortgage bonds, series G	Apr. 15, 1947	Dec. 1, 1975	44,407,000	2	3	2,220,350	Do.
Refunding and general mortgage bonds, series J	do	Dec. 1, 1995	25,107,500	2.4	3.6	1,506,450	Do.
Refunding and general mortgage bonds, series K	do	Mar. 1, 2000	17,681,500	2	3	884,075	Do.
Refunding and general mortgage bonds, series M	do	Mar. 1, 1996	16,966,500	2	3	848,325	Do.
Southwestern division 1st mortgage bonds, series A	Dec. 9, 1947	July 1, 1980	35,045,000	3½	1½	1,752,250	Do.
Convertible income bonds	Sept. 18, 1947	Feb. 1, 2010	56,547,000		4½	2,544,615	Do.
Central of Georgia:							
General mortgage bonds, series A	Jan. 1, 1948	Jan. 1, 2020	1,404,800		4½	63,216	13½ percent.
General mortgage bonds, series B	do	do	12,542,400		4½	564,408	Do.
Chicago & Eastern Illinois: General mortgage income bonds	Jan. 1, 1941	Jan. 1, 1997	12,400,500		5	620,025	None.
Chicago & North Western: Convertible income bonds, series A	Jan. 1, 1939	Jan. 1, 1999	70,107,272		4½	3,154,827	13½ percent.
Chicago Great Western. General income mortgage	Jan. 1, 1938	Jan. 1, 2038	2,741,580		4½	123,371	Do.
Chicago, Indianapolis & Louisville:							
1st mortgage income bonds, series A	Jan. 1, 1943	Jan. 1, 1983	5,999,800		4	239,992	All.
2d mortgage income bonds, series B	do	Jan. 1, 2003	7,474,996		4½	336,375	13½ percent.
Chicago, Milwaukee, St. Paul & Pacific.							
General mortgage income bonds, series A	Jan. 1, 1944	Jan. 1, 2019	47,011,200		4½	2,115,504	Do.
General mortgage convertible income bonds, series B	do	Jan. 1, 2044	35,389,300		4½	1,592,519	Do.
Bedford Belt, 1st mortgage bonds	Jan. 1, 1946	Jan. 1, 1994	233,000	2¾	1½	9,903	4½ percent.
Southern Indiana, 1st mortgage bonds	do	do	7,279,000	2¾	1½	309,358	Do.
C. T. H. & S. E. 1st and refunding mortgage bonds	do	do	8,056,000	2¾	1½	342,380	Do.
C. T. H. & S. E. income mortgage bonds	do	do	5,497,800	2¾	1½	233,657	Do.
Colorado & Southern: General mortgage bonds, series A	May 1, 1930	May 1, 1980	14,028,500	1½	2½	561,140	None.
Denver & Rio Grande:							
Mod. D. & S. L. income mortgage bonds	Jan. 1, 1947	Jan. 1, 1993	7,847,000	3	1	313,880	All.
1st mortgage bonds, series A	Jan. 1, 1943	do	28,672,300	3	1	1,146,892	Do.
Income mortgage bonds, series A	do	Jan. 1, 2018	27,314,700		4½	1,229,162	18 percent.
Duluth, South Shore & Atlantic: 1st mortgage bonds	Jan. 1, 1949	Jan. 1, 1995	4,752,700		4	190,108	None.[1]
Erie. General mortgage income bonds, series A	July 1, 1941	Jan. 1, 2015	47,536,750		4½	2,139,154	13½ percent.
Georgia & Florida: Income mortgage bonds [2]	Dec. 1, 1926	Dec. 1, 1951	1,500,000		6	90,000	6 percent from June 30, 1929.
Gulf, Mobile & Ohio:							
General mortgage income bonds, series A	July 1, 1940	July 1, 2015	5,974,600		5	298,730	15 percent.
General mortgage income bonds, series B	Jan. 1, 1945	Jan. 1, 2044	22,663,000		4	906,520	12 percent.
Minneapolis, St. Paul & Sault Ste. Marie:							
1st mortgage cumulative income bonds	Jan. 1, 1944	Jan. 1, 1971	$6,309,000		4½	$283,905	All.
General mortgage income bonds	do	Jan. 1, 1991	14,486,800		4	579,472	To extent earned.
Missouri-Kansas-Texas: Adjustment mortgage bonds, series A	Jan. 1, 1922	Jan. 1, 1967	13,555,865		5	677,793	All.

New York, New Haven & Hartford: General mortgage income bonds	July 1, 1947	July 1, 2022	62, 566, 600		4½	2, 815, 497	13½ percent.
St. Louis-San Francisco: 2d mortgage income bonds, series A	Jan. 1, 1947	Jan. 1, 2022	27, 178, 500		4½	1, 223, 033	18 percent.
Wabash:							
General mortgage income bonds, series A	Jan. 1, 1941	Jan. 1, 1981	7, 628, 700		4	305, 148	16 percent.
General mortgage income bonds, series B	do	Jan. 1, 1991	11, 047, 500		4¼	469, 519	17 percent.
Total issued in bankruptcy or receivership proceedings			828, 085, 663			37, 861, 878	

ISSUED IN MODIFICATION (REDUCTION OF FIXED CHARGES) OF CAPITAL

Atlantic & Danville:							
1st mortgage bonds	July 1, 1949	July 1, 1999	$1, 893, 800		[1] 3	$56, 814	9 percent.[3]
2d mortgage bonds	do	do	777, 750		[1] 3	23, 333	Do.[3]
Boston & Maine: Income mortgage bonds	July 1, 1940	July 1, 1970	22, 894, 000		4½	1, 030, 230	4 percent per annum.
Delaware, Lackawanna & Western:							
Income mortgage bonds (N. Y. L. & W. Division)	July 1, 1942	May 1, 1993	2, 498, 100		5	124, 905	15 percent.
1st mortgage bonds (Lackawanna of New Jersey division) series B	do	do	2, 377, 950		4	95, 118	12 percent.
U. C. & S. V. division mortgage bonds	May 1, 1942	May 1, 1992	2, 790, 600	3	2	139, 530	6 percent.
Oswego & Syracuse division mortgage bonds	Feb. 20, 1943	May 1, 1993	925, 000	4	2	55, 500	Do.
Warren division mortgage bonds	Apr. 15, 1942	May 1, 1992	1, 262, 950	4	2	75, 777	Do.
Morris & Essex division collateral trusts	July 1, 1942	May 1, 2042	11, 461, 750	4	2	687, 705	Do.
Lehigh Valley:							
General consolidated mortgage, series D	Sept. 30, 1903	May 1, 2003	14, 978, 750		4	599, 150	20 percent.
General consolidated mortgage, series E	do	do	7, 373, 500		4½	331, 808	22½ percent.
General consolidated mortgage, series F	do	do	4, 986, 000		5	249, 300	25 percent.
Midland Valley:							
Adjustment mortgage, series A	Apr. 1, 1943	Apr. 1, 1963	1, 291, 500		4	51, 660	([4]).
Adjustment mortgage, series B	do	do	462, 500		4	18, 500	([4]).
Oklahoma City-Ada-Atoka:							
1st mortgage gold bonds	Jan. 1, 1924	Jan. 1, 1954	148, 000		6	8, 880	None.
OC-SI 1st mortgage gold bonds	do	do	23, 000	2	4	1, 380	Do.
Spokane International: Income mortgage bonds, series A	Jan. 1, 1940	Jan. 1, 2013	2, 344, 800		4½	105, 516	13½ percent.
Total issued in modification (reduction of fixed charges) of capital			78, 489, 950			3, 655, 106	
Grand total			906, 575, 613			41, 516, 984	

[1] Except under specified conditions.
[2] In default. Company in receivership.
[3] Interest fixed after July 1, 1954.
[4] 12 percent after payment of 1st mortgage.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON STOCK ISSUED IN DISCHARGE OF PREFERRED DIVIDENDS IN ARREARS

Section 305 of H. R. 8300 covers the taxation to the recipient of stock dividends and distributions of stock in connection with the recapitalization of a corporation, a statutory merger or consolidation, or a reorganization involving a corporate acquisition of property or stock, or a corporate separation. The general rule there provided is that the shareholder shall not be deemed to have received income, nor shall gain or loss be recognized to the shareholder, upon his receipt of stock in such a transaction.

The general purpose of this provision is to liberalize existing law. For example, stock dividends which effect a change in the proportionate interest of the shareholder are taxable under existing law, but section 305 would exempt all stock dividends, regardless of changes in proportionate ownership effected by the issuance of such stock dividends.

Section 305 makes two exceptions to the general exemption of stock dividends and stock distributed incident to recapitalization and reorganization. Section 305 (c) (1) treats stock distributions as taxable if—

"(A) the distribution is made in discharge of preference dividends on nonparticipating stock currently owing or in arrears, or

"(B) an option is held by the shareholder whereby a distribution is payable either in stock (including rights to acquire stock) or in property."

Such a distribution, even though made solely in stock, would be taxed to the shareholder as though it were a cash dividend. Thus, where a substantial arrearage of dividends on preferred stock is discharged by the issuance of common stock, the stockholder will be required to pay a tax on the receipt of the common stock, just as though he had received cash. It is feared that as a result of this proposed provision many legitimate railroad recapitalizations and reorganizations would be prevented because of the unwelcome tax consequences to the security holders.

One of the commonest instances of such adverse effect would be the situation of a railroad company seeking to eliminate long outstanding and continuing dividend arrearages where there is no reasonable prospect that payment ever could be made in cash. This may be undertaken in connection with a merger, consolidation, alteration, or modification of the capital structure, or acquisition of one railroad by another, all of which may be effected pursuant to the provisions of the Interstate Commerce Act, or through an insolvency reorganization in a receivership proceeding or a proceeding under section 77 of the Bankruptcy Act. All of these proceedings require, in varying degrees, stockholder approval, as do most mergers of corporations effected under State law, but they are involuntary as to nonassenting stockholders.

Prerequisite to the effectuation of any such plan involving a railroad corporation is prior approval by the Interstate Commerce Commission as in the public interest. The Commission has withheld approval of capital modifications where it appeared that interest accumulations or dividend arrearages might be paid within a reasonable time. In general, the Commission approves only those plans involving interest accumulations or dividend arrearages impossible of payment in the foreseeable future and in which the elimination of such accumulations is in the public interest.

As an example, let us examine the existing Missouri Pacific situation. It is now in reorganization under section 77 of the National Bankruptcy Act, as amended. A plan proposed in February 1954 by Interstate Commerce Commission examiners provides that the holders of $70 million par value of outstanding preferred stock, on which there is $115 million of dividends in arrears, shall receive $185 million par value of common stock of the reorganized company in exchange for the preferred stock now outstanding. It is feared that, if section 305 were enacted in its present form, the stockholders would be taxed as though they had received a cash dividend equivalent to the fair market value of $115 million par value of common stock which they are scheduled to receive. This would obviously be inequitable, for this is an insolvency reorganization where the stockholder is required to accept a "grading down" of his securities—that is, he is required to accept a lower ranking security in the reorganized company than that which he held in the old company. Furthermore, he is provided no cash with which to pay a tax and, if taxed upon the transaction, he will be under a necessity of selling out a part of his interest in the company to provide funds for tax payment. This, we submit, is not only unrealistic but unwise, for it would cause

stockholders to withhold their consents from reorganizations otherwise acceptable and certainly desirable in the public interest.

Furthermore, in many ordinary financial transactions where stock or securities are exchanged in mergers or recapitulations, it is frequently necessary, in the absence of cram-down provisions, to provide money for the purchase or redemption of stock from nonassenting stockholders who refuse to accept the plan. Likewise, under many State merger statutes, the right is given to dissenters to turn in their stock at its appraised value. Although no real option is in such instances intended or expressly given to the stockholder either to make an exchange or to be bought out, it is evident that section 305 (c) (1) (B) could be construed to apply to such a situation. Although we doubt that the proponents of section 305 intended that stock issued in such a situation should be treated and taxed as though it were a cash dividend, nevertheless, the section might well be interpreted to bring about that result. This would seriously hamper legitimate transactions of this character and could hardly be regarded as in the public interest.

Section 20b of the Interstate Commerce Act was enacted by Congress in furtherance of the national transportation policy and in the public interest. Because of the adverse effect on public service, the interruption of employment, the impairment of railroad credit and the marketability of their securities, Congress deemed it necessary to provide for alteration or modification of railroad capital structures under section 20b so as to permit them to discharge interest and preferred dividend accumulations.

In even greater degree the same principles apply to railroad reorganizations effected in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, as amended, both of which forms of reorganization have long been recognized as worthy of special treatment under the tax laws.

Furthermore, all other issues of stock and securities in the railroad industry require approval of the Interstate Commerce Commission which, prior to authorizing the issuance, must find that such issuance of stock or securities—

> "(*a*) is for some lawful object within its (the corporation's) corporate purposes, and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by a carrier of service to the public as a common carrier, and which will not impair its ability to perform that service, and (*b*) is reasonably necessary and appropriate for such purposes." (Sec. 20a, Interstate Commerce Act.)

Under such safeguards, the potentialities for tax avoidance simply do not exist in the railroad industry.

Railroad securities are widely held by the public. As stated by the Ways and Means Committee on page 39 of its report on H. R. 8300: "Publicly held corporations usually have a corporate existence separate from that of their shareholders and as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level." Obviously, this is true with respect to railroad recapitalizations and reorganizations.

In all instances here discussed, assents must be obtained from security holders before any plan of reorganization, alteration, or modification can be consummated. The levying of a tax upon the issuance of stock in discharge of preferred stock dividends in arrears would cause security holders to withhold their assents to otherwise acceptable plans and may well prevent the consummation of a plan deemed by the Interstate Commerce Commission to be in the public interest.

In view of the above considerations, it is urged that:

(1) Section 305 (c) be deleted and revision of the law along the lines there indicated postponed pending further inquiry and investigation.

(2) If enactment of such a provision be deemed necessary at this time, a paragraph should be added to the effect that section 305 (c) shall not apply where the issuance of securities by a railroad corporation is subject to the prior approval and authorization of the Interstate Commerce Commission.

(3) In any event, provision should be made that no income gain or loss shall be recognized to the security holders upon the receipt of securities or stock in a recapitalization or a reorganization of a railroad corporation or in an alteration or modification of its capital structure, approved by the Interstate Commerce Commission. Except for approval by the Interstate Commerce Commission in lieu of the courts, such provision would be comparable to that contained in section 371 (b) of H. R. 8300 applicable to insolvency reorganizations of nonrailroad corporations.

(4) The reference to "option" in section 305 (c) (1) (B) be clarified so that it cannot be construed to apply in circumstances where a nonassenting shareholder to an exchange may have his shares called by a railroad company in connection with a change in its capitalization.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON DISTRIBUTION OF SECURITIES UNDER SECTION 306

Section 306 of H. R. 8300 provides rules for the taxation of shareholders and security holders upon the receipt of new stock, new securities, and cash or other property, in the case of certain recapitalizations and reorganizations. Among other things, it would treat as taxable income securities received in satisfaction of arrearages of interest. Although the report of the Ways and Means Committee states that the section is not intended to apply to insolvency reorganizations, nevertheless the section is specifically made applicable to transactions described in section 305, which section seems to embrace all recapitalizations. Consequently, it would seem that section 306 would be applicable to the reorganization of an insolvent railroad corporation effected through recapitalization. Furthermore, the section would be applicable to an alteration or modification of the capital structure of a railroad corporation effected under section 20b of the Interstate Commerce Act.

The provisions of section 306 would unduly burden security holders with tax liability upon the exchange of their old securities for new securities in the reorganized company. In a railroad reorganization or recapitalization a bondholder ordinarily receives new securities having a face value or par value equal to the principal and unpaid interest on the old bond. For example, in 1 of the pending reorganizations the debtor has convertible bonds outstanding on which interest has not been paid for over 20 years. The bondholder's claim consists of $2,219 for each $1,000 bond, of which $1,219 is past due and unpaid interest. In satisfaction of his claim the bondholder is scheduled to receive securities of the reorganized company in the following amounts:

General mortgage income bonds, face value	$400
Preferred stock, par value	1,819
Total	2,219

Section 306 (e) provides that upon the receipt of the new securities this bondholder would be required to pay a tax on interest income measured by the fair market value of $1,219 face value of the new securities received. Apparently this would be true whether or not the fair market value of all the new securities received exceeded the cost to the bondholder of his old bond.

This proposal would be an unjustifiable impediment to the recapitalization or reorganization of distressed railroads. The security holder would be provided in the recapitalization no money with which to pay a tax and would be under the necessity of selling a part of his holdings to satisfy the tax collector. In most instances he would have realized no gain but would actually have suffered a loss in a reorganization of this kind. It would be both unrealistic and unwise to impose a tax under such circumstances. The tax would rest upon the fiction of income received, but in reality it would amount to a capital levy.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON 85 PERCENT PENALTY TAX ON REDEMPTION OF PREFERRED STOCK, INCOME BONDS, AND DEBENTURES

Section 309 of H. R. 8300 imposes a penalty tax upon a corporation if it redeems "nonparticipating stock," which is defined in section 312 to include preferred stock, income bonds, and debentures. The tax amounts to 85 percent of the value of the securities or property paid out in redemption of such nonparticipating stock.

Under section 309 (a), the tax is imposed on a redemption occurring within 10 years from the date of the issuance of the nonparticipating stock. Section 309 (c) provides, however, that with respect to stock issued prior to January 1, 1954, the issuing date shall be deemed to be January 1, 1954. Thus, as to all outstanding preferred stock, income bonds, and debentures, this penalty tax of 85 percent will be imposed on all redemptions made prior to January 1, 1964, except as to redemptions specifically exempted under section 309.

The report of the Ways and Means Committee indicates, at page A91, that the evil intended to be reached by section 309 is the preferred stock bailout. Apparently this involves the issuance of preferred stock as a dividend on common stock, followed by a redemption of the preferred stock for cash. Thus, the stockholder may in effect enjoy a cash distribution without being subjected to tax thereon as a dividend, at the same time maintaining his original position as to proportionate ownership in the company.

It is not known whether this has been a common practice among corporations whose stock is closely held, but certainly, so far as known, there has been little, if any, of it among publicly held corporations and, so far as known, none of it among railroad corporations.

This proposal presents a serious problem for a large number of railroads. In practically all railroad reorganizations of recent years, either through equity receivership or pursuant to the Bankruptcy Act, income bonds and preferred stock of the reorganized company have been issued in exchange for securities of the predecessor companies. In such instances, the Interstate Commerce Commission has usually provided for a mandatory sinking fund which contemplates that the income bonds will be redeemed in whole or in part prior to maturity. The issuing corporations are under the necessity of redeeming such bonds pursuant to such sinking fund provisions. Thus, the railroads having these income bonds are faced on the one hand with a mandatory redemption requirement and on the other hand with an 85 percent penalty tax if such bonds are redeemed.

Furthermore, it is often possible for railroads to purchase their income bonds and preferred stock at a discount in the open market, and this is often in the public interest. This proposed provision of law would impose a prohibitive penalty on such purchases.

Section 309 (a) (3) purports to grant some relief from this penalty tax in the case of nonparticipating stock issued for securities or property. It is intended to provide that the penalty shall attach only to that part of the redemption price which exceeds 105 percent of the fair market value of the securities or property paid in for the stock redeemed.[1] It is not clear just how this would work out with respect to railroad reorganizations. Suppose, for example, that in such a reorganization the holders of outstanding first mortgage bonds of the distressed company receive in exchange income mortgage bonds of the reorganized company, the interest on which is payable only as earned. Suppose the first mortgage bonds were selling at 50 at the time of the reorganization. Further, let us assume that the reorganized company redeems some of these income bonds at their face value of $100 within 10 years from the date of their issuance. Will the exemption from the 85 percent penalty tax apply only to 105 percent of $50, or $52.50, leaving the corporation to pay a tax of 85 percent of $47.50 on the redemption? It is believed that this is the result of section 309 as it now stands. This is an appalling price to be paid for a perfectly legitimate non-tax-avoidance transaction typical railroad reorganization.

It is also not clear from the language of section 309 whether this penalty tax would be imposed upon a redemption of securities incident to the execution of a plan of reorganization, recapitalization, merger, or consolidation under the Bankruptcy Act or the Interstate Commerce Act. The committee report states, at page A93, the penalty tax shall not apply to redemptions incident to certain corporate acquisitions of stock and property and certain corporate liquidations. It is not clear, however, that section 309 in its present form exempts such redemptions. It is believed that section 309 (b) should be clarified so as to exempt specifically from the penalty tax those transactions referred to in the committee report and all reorganizations, recapitalizations, mergers, and consolidations of railroad corporations under the Bankruptcy Act or the Interstate Commerce Act.

There would also appear to be no valid reason for subjecting the redemption of nonparticipating stock, income bonds, or debentures to a penalty tax under section 309 if they have been outstanding for more than 10 years. From subsection (a) it appears that the statute was only intended to condemn redemption of such securities within 10 years from the date of their issuance. The presumption is that if such securities have been outstanding for as much as 10 years, they must be presumed to have been issued without intent of such tax avoidance as is attempted to be cured in the enactment of section 309. Under this principle, it would seem clear that any such stock or bonds which have been

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[1] This is clear from the title of the subsection. However, presumably through oversight, the text refers only to the fair market value of property, omitting securities.

outstanding for 10 years or more have already met the time requirement of the statute. We find, however, in section 309 (c) a provision to the effect that stock already outstanding shall be deemed to have been issued on January 1, 1954. This imposes an unfair and inequitable penalty on corporations which have issue preferred stock, income bonds, and debentures more than 10 years ago and which may wish to retire or be required to retire such stock or bonds now for a valid business purpose.

Based on all of the above considerations, the railroad industry urges—

(1) That section 309 be deleted or be revised so as to apply only to the evil intended to be cured, apparently the preferred stock bail-out practice among closely held corporations.

(2) Section 309, if retained, should not apply to any railroad securities. All such securities issued since 1920 have been approved by the Interstate Commerce Commission prior to their issuance. Such approval involves a finding that the issuance is in the public interest, and this would be entirely incompatible with the preferred stock bail-out evil here involved.

(3) Where nonparticipating stock is issued in exchange for outstanding debt and is subsequently redeemed, the penalty tax of 85 percent should be inapplicable to the redemption price to the extent of 105 percent of the debt discharged upon the issuance of the stock.

(4) The penalty tax should not apply to the redemption of any nonparticipating stock after 10 years from the actual date of its issuance. The provision that stock already outstanding shall be deemed to have been issued on January 1. 1, 1954, should be deleted.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON ACCRUAL OF REAL PROPERTY TAXES

The railroad industry pays very substantial real property taxes in each of the 48 States. These State-taxing statutes vary so widely and are so complicated that it has been impossible since the release of H. R. 8300 to make the required investigation to determine the effect of section 461 with respect to the accrual of real-property taxes.

Under present law, it has generally been held that a real-property tax accrues and is deductible as of the date when it becomes a lien on the property. Nevertheless, the tax usually covers a definite period of time, either a calendar year or some fiscal year. Taxpayers keeping their books on an accrual basis have generally been required to take the deduction in the taxable year in which the lien date falls.

The purpose of section 461 is to permit real-property taxes to be accrued and deducted over the period covered by the tax. For example, take the city of New Orleans real-property tax which became a lien on January 1, 1953, and which covers the calendar year 1954. Under present law, the tax was deductible in 1953; under the general rule stated in section 461 of H. R. 8300, this tax would be deductible in 1954. The special rule under section 461 (c) (2) provides, however, that the general rule permitting the accrual of a tax over the taxable period shall not be applicable to any tax which has been deductible prior to January 1, 1954, under the previous law. Consequently, corporations owning real property in New Orleans would not be permitted to deduct any real-property tax at all in their 1954 returns.

The same thing is true in the State of Alabama, where the taxes for the year 1954 became a lien on the property on October 1, 1953. The same thing is true in Kentucky, where the real-property taxes for the fiscal year ended June 30, 1954, became a lien on January 1, 1953. No doubt further investigation would show that this is also true in other States.

The railroad industry submits that any taxpayer which regularly reports income and expenses on the accrual basis should be permitted to deduct a full year's real-property tax in its first taxable year under H. R. 8300 if enacted into law. The special rule covering the transition period should be broadly stated so as to bring about this result.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON PAY-AS-YOU-GO TAX PAYMENTS BY CORPORATIONS

The railroad industry urges the elimination of the provisions in H. R. 8300 relating to the declaration and payment of estimated income taxes by corporations. It believes that these provisions are unsound and that they impose an unjust burden.

Under section 6016 of H. R. 8300, corporations whose tax liability exceeds $50,000 would be required, beginning in 1955, to file a declaration of estimated income tax for the current year and to pay a portion of such tax in quarterly installments. The first declaration would be due September 15, 1955, accompanied by a payment of 5 percent of estimated tax liability for that year, a further payment of 5 percent being due on December 15. These payments are scheduled to be increased 5 percentage points each year until, at the time the provisions become fully effective in 1959 and thereafter, corporations will be paying 25 percent of their estimated tax liability for the current year on September 15 and again on December 15

The proposed system of estimated income-tax payments by corporations is patterned to a large extent after the system in effect with respect to individuals. As in the case of individuals, severe penalties are imposed for failure to file a declaration of estimated tax, failure to pay the estimated tax, and for substantial underestimation of the tax. The apparent similarity to the estimated tax provisions with respect to individuals gives to the proposal a deceptive appearance of an attempt to provide equality of treatment between individuals and corporations. In reality, however, the purpose of the plan is simply to provide increased revenues during the first half of the Government's fiscal year at the expense of 10 percent of the Nation's corporate taxpayers.

The proposed estimated tax payments by corporations are actually and simply a result of the plan adopted as a part of the Revenue Act of 1950. Prior thereto, corporations paid their income-tax liability in four equal quarterly installments, in March, June, September, and December of the following year. Under the method adopted in the Revenue Act of 1950, the payments in the first and second quarters have been gradually increased with a corresponding decrease in payments made in the third and fourth quarters. This method will become fully operative in 1955 with respect to the corporate-income liability for 1954. In that year, 50 percent of the taxes for 1954 will be paid in each of the first and second quarters, with no payments being made in the third and fourth quarters. The inevitable result is that the Government revenue collections in the third and fourth quarters of the calendar year have fallen sharply. The obvious purpose of the proposed estimated payments is to relieve this situation by again requiring corporate-tax payments in the third and fourth quarters. This is to be done, however, not by reversing the plan under the 1950 act, thereby relieving corporations of the accelerated tax payments, but by more acceleration of such payments. In operation, the plan now proposed under H. R. 8300 would require corporations to pay, roughly, 110 percent of their annual tax bill in each of the years 1955 through 1959. There is no justification for imposing this burden on corporations. The pay-as-you-go system of income-tax payments for individuals was instituted at a time when the revenue needs of the country for prosecution of World War II raised the individual tax rates to previously unheard-of levels. At the same time, war-inspired inflation increased individual incomes generally. In order to ease the task of the individual in paying the resulting heavy income taxes, and to insure to the Government maximum collection of such taxes, the Current Tax Payment Act of 1943 was enacted. The necessity of this method of tax payment for individuals is recognized by all.

No such reasons exist at this date, however, for the introduction of this method with respect to corporate tax payments. There has been no change in the corporate tax rates and no change in the economy as a whole which require a method of collection from corporations different from that presently in effect. Furthermore, there is no problem with respect to collection which justifies this radical change. The pay-as-you-go provisions of H. R. 8300 would apply only to corporations which can reasonably be expected to have in excess of $50,000 income tax per year. According to the estimates set forth at page 103 of the House Ways and Means Committee report accompanying H. R. 8300, it is expected that these provisions would affect only about 10 percent of the corporate taxpayers in the country who account for approximately 90 percent of the total corporation income-tax payments. It has not been suggested by

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anyone as a reason for such a proposal that there is doubt as to the ability of these corporations to pay their income-tax liabilities.

To estimate income-tax liability before the close of the taxable year is a particularly burdensome task for the railroads. The operation of such corporations are essentially complex. Under present law, it has been found generally impossible to determine the taxable income or tax liability within 2½ months after the close of the year. Consequently, it has become common practice to obtain extensions, up to 6 months, of the time within which the return must be filed. The Internal Revenue Service, recognizing the difficulties which corporations face, has now changed its practice so as to provide for the granting of automatic 90-day extensions merely upon making a request therefor. It would be virtually impossible for a railroad to estimate with any degree of accuracy before the close of its taxable year the results of its operations for the year. The provisions of H. R. 8300, nevertheless, would impose heavy penalities for substantially underestimating the tax.

Many corporations are extremely sensitive to changes in business conditions, with the result that a profit from operations in the early part of the year may be completely wiped out by adverse business conditions in the latter part of the year. Railroads are particularly vulnerable in this regard, and a readjustment in business conditions has a far greater immediate effect upon the railroads than upon business generally. For example, until September 1953, economic conditions led the railroad industry generally to expect that 1953 would be a year of heavy traffic and good profits. However, the business readjustment which began in October affected large segments of the railroad industry with a marked impact, so that declining traffic and sagging revenues during the last 3 months of the year substantially reduced the income under the level which only a few weeks previously had been expected. Had the railroads been required to file a declaration of estimated tax in September 1953, and to accompany that declaration with 25 percent of the estimated tax for the year, based upon conditions as they then appeared, the payment of estimated tax would in some cases have exceeded the actual tax liability for the entire year. Having once made the payment, however, the railroad would be unable to obtain a refund of the overpayment until after the return for the year had been filed, and audited by the Internal Revenue Service; a process very often requiring up to 10 years to accomplish. It would be manifestly unjust to require railroad corporations to make these payments and then to permit long periods of years to elapse before an overpayment could be refunded in case the corporation should overestimate its tax liability.

In view of the foregoing, the railroad industry suggests that sections 6016, 6074, 6154, and 6655 of H. R. 8300 be deleted from the bill. If, however, it should nevertheless be determined that the revenue requirements necessitate current tax payments by corporations, the railroads both recommend and urge that the provisions of H. R. 8300 relating to such payments be amended to provide for an immediate refund of any overpayment by a corporation of its quarterly payment of estimated tax; such a refund to be allowed immediately on the filing of a claim therefor.

Statement of Association of American Railroads on Depreciation

Section 167 of H. R. 8300 is designed to afford relief with respect to depreciation charges and thus stimulate improvement and replacement of plant and equipment. Section 167 (b) of the bill would permit charging depreciation on the declining-balance method at double the straight-line rate. Application of this provision would result in a chargeoff of twice the existing straight-line rate in the first year following acquisition and a recovery of about two-thirds of cost in the first half of the estimated useful life of the property.

It is recognized that this provision, if enacted into law, would afford substantial relief in respect of depreciation charges pertaining to short-lived depreciable assets. For example, owners of motor trucks used in long hauls, having an estimated life of 7 years and a resulting straight-line depreciation rate of 14 percent would be permitted an annual deduction of 28 percent applied to the declining balance and would recover two-thirds of the cost in 3½ years; and this is illustrative of the effect of the proposal upon other short-lived assets.

But this proposal would afford relatively little relief to the railroad industry. This results from the fact that by reason of the very nature of its enterprise, the investment of the railroads in depreciable property is to an overwhelming extent

in long-lived assets. Thus, according to bulletin "F," issued by the Internal Revenue Service, railroad freight cars are assigned a life of 28 years; steam locomotives, 30 years; and electric locomotives, 38 years. To recover two-thirds of the cost of these assets would require 14 to 19 years under the proposal, as contrasted with 3½ years in the case of long-haul trucks. Much longer periods would be required to recover the cost of various items of railroad fixed property such, for example, as bridges which have an estimated life ranging from 40 to 100 years.

In a word, it appears that the proposed measure for relief in respect of depreciation would accord maximum relief to industries which depend upon short-lived property, and negligible relief in the case of industries such as the railroad industry which must rely in the main upon investment in relatively long-lived property. The doubling of a straight-line 10 percent depreciation rate affords substantial relief, but the doubling of a depreciation rate of 3 percent (the average railroad rate) affords no substantial relief whatever. It will not afford a real stimulus to investment in improvements to the railroad plant because recovery of only two-thirds of the cost of improvements in 15 years will not be of much help in financing.

It is unnecessary to emphasize the dependence of the country upon an adequate rail transportation system from the standpoint of the domestic economy and the national defense. The tremendous contribution of the railroads to the World War II effort is well known. They handled 97 percent of all organized movement of military personnel and carried more than 90 percent of all military freight. The vital role which the railroads would be called upon to perform in any other similar national emergency is well recognized. Consequently, improvement of the railroads and their maintenance at the highest practicable standard is a matter of great importance.

With respect to freight cars, Defense Transport Administrator Knudson stated in Railway Purchases and Stores magazine, issue of January 1954, that to attain the minimum defense goal of 1,850,000 freight cars would require 75,000 to 100,000 additional cars, and that even this number would not suffice for total mobilization. As pointed out by Mr. Knudson: Between the Korean outbreak in mid-1950 and December 1, 1953, freight car ownership increased by only 52,000 cars. This modest increase, including replacement of cars retired, required freight car investment to be increased from $4,457 million to $5,177 million. A further increase of 75,000 cars would cost the roads $450 million more, exclusive of the cost of replacing cars retired. Mr. Knudson went on to say: "This is a 'sacrificial' contribution * * * to urge in the presence of high prices, uncertain rate structures and declining traffic, but I urge it just the same in the interest of national defense."

Increasing the freight car supply and the extension and improvement of other railroad facilities present a practical problem. Long-term borrowing on fixed property is prevented because of the fact that all such property is already covered by existing mortgages. Short-term borrowing is difficult because of the fact that equipment obligations have increased from $773 million to $2,582 million, or 300 percent, in the 7 years ending December 31, 1952, and this source threatens to dry up.

The raising of equity capital is hampered by the low rate of return on railroad property. Following are the income figures for the railroad industry in 1953:

	Billions
Gross revenue	$10.7
Operating expenses	8.1
Taxes	1.2
Net railway operating income	1.1

The net railway operating income represents a return of only 4.18 percent on the industry's net investment of $26.5 billion.

The railroads urge that favorable consideration be given to one or another of the three alternatives stated below as measures to be made applicable to depreciation of railroad facilities acquired after December 31, 1953:

(1) An annual allowance for depreciation at any rate from zero percent to 20 percent.

(2) Accelerated amortization, or the equivalent thereof, over a period of 5 years (analogous to sec. 124B of the code), with a proviso that such a deduction need not be taken in a year when it furnishes no tax benefit.

(3) Adoption of the amendment contained in H. R. 8300, previously described, subject, however, to the proviso stated in (2), and to the further proviso that railroad assets, exclusive of buildings, shall be deemed to have an estimated life of not more than 20 years.

All three proposals embody, in one form or another, the tax benefit rule—a rule predicated on simple justice if, indeed, not actually required by constitutional limitations. For if a taxpayer is prevented from recovering his capital free of tax, by virtue of being compelled to charge off depreciation in a year when he earns on income, then the income tax becomes pro tanto a capital levy. Only the tax benefit rule allows the taxpayer to recover the full cost of plant out of earnings. The adoption of proposal (1) would accomplish that result by giving the taxpayer absolute control of the depreciation which he would charge off in any year within the limits of zero percent to 20 percent.

Proposal (2) is quite different. Once having adopted the 20-percent rate of amortization it would have to be continued. It should be noted, however, that this is to be coupled with the tax-benefit rule so that the taxpayer will not be required to charge off such amortization, and thus exhaust the cost of the property, in any year in which there would be no tax benefit in taking a deduction for such amortization.

Proposal (3) merely presents suggested modifications of the declining-balance method of depreciation as contained in H. R. 8300. The association's suggestion is that if this proposed measure is enacted, business assets should be deemed to have a useful life of not more than 20 years. This would mean that there would be a minimum depreciation rate of 5 percent under the straight-line method and, as to any taxpayer desiring to avail himself of the opportunity to adopt the declining-balance method as proposed in H. R. 8300, a minimum rate of 10 percent under such method would be afforded. This might give some measure of impetus to the expansion of railroad plant and equipment as the proponents of the measure obviously desire.

In order to implement the tax-benefit rule involved in proposals (2) and (3), it would be necessary to amend section 1016 (a) of H. R. 8300 so as to provide that the basis of property shall be adjusted for depreciation only to the extent that the deduction thereof has reduced taxable income for some taxable year.

Statement of Association of American Railroads on Consolidated Returns

A. ELIMINATION OF 2 PERCENT PENALTY ON FILING CONSOLIDATED RETURNS

The railroad industry continues to urge the elimination of the 2 percent penalty tax upon the filing of consolidated returns by affiliated groups of corporations. Although President Eisenhower recommended this in his budget message, H. R. 8300 provides for the continuation of this penalty.

The purpose of consolidated returns is well known. Such returns are based upon the principles of levying the tax according to the true net income of a single enterprise, even though the business is operated through more than one corporation. They recognize the business entity as distinguished from the separate corporate entity. Unless the affiliated group as a whole, in the conduct of its business enterprise, shows net profits, the affiliates conducting the business have realized no gain.

The use of consolidated returns by affiliated groups has been provided for in the tax laws since the days of the First World War, and has received the explicit approval of the Treasury Department. Consolidated returns were first provided for in the regulations relating to the excess-profits tax imposed by the Revenue Act of 1917. In the Revenue Act of 1918 such returns were given congressional sanction and were made mandatory with respect to both income and excess-profits taxes. Beginning with the 1921 Revenue Act and continuing until 1934, the use of consolidated returns was permitted for affiliated groups of corporations generally. The 1934 Revenue Act restricted the privilege of filing consolidated returns to railroad corporations only. This limited privilege extended from 1934 until 1940, at which time affiliated groups generally were permitted to file consolidated excess-profits-tax returns. Under the Revenue Act of 1942 the privilege of filing consolidated income-tax returns was once again extended to all types of affiliated groups.

Thus, consolidated returns have been a part of the revenue laws for 35 years. Over this period they have received repeated approval as the proper method of computing income in the case of a group of corporations, which, in fact, constitute a single business enterprise. For this reason, proposals which have been made at various times to abolish the use of such returns have consistently been unsuccessful. During the consideration of the Revenue Act of 1928, when such a proposal was made, the use of consolidated returns was strongly defended by the Senate Finance Committee in the following language:

"The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes." (S. Rept. 960, 70th Cong., 1st sess.)

The Treasury Department has also opposed the abolition of consolidated returns, adding to the reasons given above, the fact that consolidated returns provide ease in administrative handling. (Statement of the Assistant Secretary of the Treasury Dec. 15, 1933.)

The above clearly demonstrates that the use of consolidated returns should not properly be considered a privilege conferring any special advantage or preference over the use of separate returns. Rather, they should be considered a necessary and proper method of reporting the income of affiliated groups of corporations in order clearly to reflect the net income of the group. "Much of the misapprehension about consolidated returns will be removed when it is realized that it is only when the corporations are really but one corporation that the permission to file consolidated returns is given, and that *no ultimate advantage under the tax laws really results*. The present law permits the filing of consolidated returns only where one corporation owns at least 95 percent of the stock of the other corporation or if at least 95 percent of the stock of both corporations is owned by the same interest. The provision embodies the businessman's conception of a practical state of facts." [Emphasis supplied.] (S. Rept. 960, 70th Cong., 1st sess.) Consequently, there appears to be no justification for the imposition of a penalty upon the filing of such returns.

From the inception of consolidated returns during the First World War until 1932, no price was exacted for their use. The penalty first appeared in the Revenue Act of 1932, when the House of Representatives proposed an additional tax of 1½ percent for their use. This proposal met with strong opposition in the Senate upon the ground that there was no justification for the imposition of a penalty tax. The Senate Finance Committee report contained the following pertinent reasons:

"The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. *No improper benefits are obtained from the privilege.* Your committee believes that it is highly desirable, both from the point of view of the administration of our tax laws and the convenience of the taxpayer, that the filing of consolidated returns by affiliated groups of corporations be continued, * * *. It is difficult to justify the exaction of a price for the use of this form of return." [Emphasis supplied.] (S. Rept. 665, 72d Cong., 1st sess.)

Nevertheless, a penalty at a compromise rate of three-fourths percent was imposed.

The penalty rate was increased to 2 percent by the Revenue Act of 1934, the same rate which is in effect at the present time. At that time the House Ways and Means Committee offered the following reasons in support of the imposition of the penalty:

"In the past, when any corporation could carry forward a net loss from 1 year to another, the consoldiated group did not have such a great advantage over the separate corporation. *Now that this net loss carryover has been denied,* the advantage of the consolidated return is much greater on a comparative basis." (H. Rept. 704, 73d Cong., 2d sess.) [Italics supplied.]

Any advantage which may be thought to have existed in favor of consolidated returns over separate returns in this respect has now completely disappeared. The Revenue Act of 1950 amended the net operating loss provisions so as to permit a net operating loss carryback of 1 year, and a net operating loss carryover 5 years. A similar carryback and carryover of the unused excess-profits credit was provided for in the Excess Profits Tax Act of 1950. Under H. R. 8300, it is proposed to permit a 2-year carryback and a 5-year carry forward of a net operating loss. The liberalization of the carryback and carryover provisions thus provided is intended to afford corporations the opportunity to offset loss operations against profitable operations, and place them, in this respect, on a basis of equality with those who employ consolidated returns. There is no reason, therefore, to continue to impose a 2-percent penalty on the use of such returns.

The use of consolidated returns is particularly appropriate in the case of the railroads. Although the railroads must, for purpose of convenience and necessity, operate across State lines, various legal provisions, as well as financial requirements, often necessitate the existence of subsidiary companies organized under the laws of the various States through which a railroad operates. As a result of these and other considerations the major railroad systems of the country have developed, not only by mergers and consolidations, but also by a process of leasing operating properties from companies which have continued to retain their own corporate existence. This unique position of the railroads in the Nation's economy, and the special applicability of consolidated returns to the railroad industry, were recognized by Congress when, in 1934, it abolished the use of consolidated returns for all except railroad corporations.

Considered either from the viewpoint of equity or administrative convenience, consolidated returns should be encouraged and the 2 percent penalty on the use of such returns should be eliminated in view of outstanding as well as proposed net operating loss carryover provisions. There is no justification for penalizing those who must file a consolidated return because of the peculiarities of their corporate structures. This is particularly true of the railroads, which, in many instances, are unable to merge or consolidate their subsidiaries and thus achieve the result of a consolidated return without being subjected to the penalty. With corporate rates at 52 percent, the continuance of this 2 percent penalty on the use of consolidated returns results in a tax rate of 54 percent. It is, therefore, urged that this penalty tax be eliminated and that section 1514 (a) of H. R. 8300 be amended by deleting therefrom the last sentence.

B. OPTIONAL USE OF CONSOLIDATED RETURN WHERE THERE IS 80 TO 95 PERCENT STOCK OWNERSHIP

For many years, the railroad industry has urged the elimination of the 2 percent penalty on the filing of consolidated returns. In H. R. 8300 this proposal has not been adopted despite the President's recommendation for its elimination. Instead, H. R. 8300 provides for reducing from 95 to 80 percent the stock ownership requirements for the filing of consolidated returns. It should be noted that the proposed liberalization, coupled with the retention of the 2 percent penalty, imposes a burden upon the railroad industry which requires further correction.

The effect of the liberalization proposed in section 1502 of the bill is to require the mandatory inclusion in a consolidated return of all companies which are more than 80 percent owned. Once an election to file a consolidated return is made, it cannot be changed in the absence of certain conditions elsewhere specified in the bill. Under the 95 percent stock requirement of existing law, some affiliated groups have filed consolidated returns and paid the 2 percent penalty. However, under the liberalization provided for in H. R. 8300, the mandatory inclusion of income-producing affiliates, which previously were not required to be included within the affiliated group because not 95 percent owned, creates an added tax burden because of the 2 percent penalty on the income of corporations which must be added to the group. It is not the liberalization of the stock ownership provision in the bill which precipitates the difficulty; it is the 2 percent penalty on the income of the 80 to 95 percent owned affiliate.

The inclusion in the bill of this liberalization provision emphasizes the necessity of removing the 2 percent penalty. If this be deemed not possible at present, then so long as the 2 percent penalty continues, the inclusion of companies whose stock is owned more than 80 but less than 95 percent should be optional, not mandatory. Otherwise, the adoption of this liberalization provision will in some instances result in additional tax burden rather than the relief which is intended.

C. INCLUSION OF LESSOR COMPANIES IN CONSOLIDATED RETURNS

For several years the railroad industry has urged that where a railroad company leases the property of another railroad company and the lessee is obligated to pay the lessor's income tax, the two companies should be permitted to file a consolidated return, without any stock ownership requirement. H. R. 8300 affords no relief in this respect.

Under present law, seriously inequitable tax consequences result in many cases from the operation of the properties of one railroad corporation by another under a long-term lease. Many of the railroad systems have been developed by leasing the properties of other companies, rather than by merger or consolidation. The leases are for long periods of time, practically in perpetuity. In the typical case, the lessee assumes the complete management and control of the properties of the lessor and incorporates them into its railroad system. The leased line becomes an integral part of the railroad system, constituting in many cases a part of a through route. Despite this close integration, however, in the absence of the required stock ownership by the lessee, the lessor companies are not includible in a consolidated return.

It is submitted that the lack of stock ownership should not be controlling to preclude the use of a consolidated return in a situation of this kind. The intimacy of the business activities and obligations of railroad lessors and lessees is closer than would usually be the case where there is sufficient stock ownership to qualify for the use of a consolidated return. For example, under the terms of the typical railroad lease, the lessee is bound to pay as rental all the expenses of the lessor, including income and excess profits taxes, and an amount sufficient to pay a fixed dividend on the lessor's capital stock. Although in many cases the dividend is paid directly to the stockholders of the lessor by the lessee, it nevertheless constitutes income of the lessor corporation on which income tax must be paid. Pursuant to the terms of the lease the lessee must pay the income tax thus imposed upon the lessor. Such a relationship, springing from a lease, supports the general business entity concept and should be a basis for the right to file a consolidated return.

A serious inequity arising under present law occurs in a taxable year when the lessee, the operating company, has no net income due to operating losses, but for the same taxable year the lessor has net income due to the dividend rental. In such a situation the lessor is subject to income tax on the rental income but the lessee may get no tax benefit from the deduction of the rental payment because of its deficit. Thus, there is the anomalous situation where, although the operation of the properties has resulted in a deficit, nevertheless an income tax must be paid by the lessee on account of the dividend rental payment to the lessor's stockholders. The business enterprise suffers a loss, but it nevertheless pays an income tax. Certainly such an inequitable result should not be continued and it may be corrected by permitting railroad lessor and lessee companies to file a consolidated return irrespective of stock ownership.

It is submitted that, regardless of stock ownership by the lessee, the inclusion of all lessor companies in consolidated returns with the operating company which is obligated to pay the lessor's income tax, would more clearly reflect the net income of the single business enterprise involved, i. e., the operations of the railroad system, and would thus be in accord with the general nature and purpose of consolidated returns.

LEGISLATIVE PROPOSAL

Amend section 1502 of H. R. 8300 by adding thereto the following new subsection:

"(h) Affiliation of Lessor Railroad Companies.—In the case of a railroad corporation subject to part I of the Interstate Commerce Act, the railroad properties of which have been leased to another such railroad corporation by an agreement entered into prior to January 1, 1954, where the lease requires the lessee to pay the Federal income and excess profits taxes imposed on the

lessor, such lessor corporation may be included in consolidated income and excess profits tax returns with the lessee corporation, regardless of the percentage of the lessor's stock owned by the lessee or one or more other corporations in an affiliated group including the lessee, provided, however, that such lessor corporation includible in the affiliated group solely by reason of the provisions of this subsection shall not be liable for an amount of income and excess profits taxes in excess of the amount of such taxes for which it would have been liable if it had filed separate income and excess profits tax returns in its own behalf."

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON INCOME FROM DISCHARGE OF INDEBTEDNESS IN RAILROAD RECEIVERSHIP AND BANKRUPTCY REORGANIZATIONS

SECTION 108

Section 108 (b) of H. R. 8300 is intended to extend to December 31, 1955, the provisions of section 22 (b) (10) of the Internal Revenue Code which would otherwise expire at the end of the current calendar year. This section excludes from the gross income of a railroad corporation the amount of any income attributable to the discharge of its indebtedness pursuant to a court order in a receivership proceeding or in a proceeding under the Bankruptcy Act.

Section 22 (b) (10) was incorporated in the code by the Revenue Act of 1942 as remedial legislation to avoid the paradox of imposing high income tax on railroad corporations emerging from judicial reorganization or bankruptcy on alleged income resulting from reduction or cancellation of indebtedness pursuant to such proceedings. It was realized that such an imposition would probably put the reorganized railroad right back in receivership or bankruptcy; the commencement of a vicious circle to the detriment of the economy as a whole and to the railroad industry in particular. It is the position of the railroad industry that the provisions of section 22 (b) (10) should be made permanent or at the least continued through 1957.

In 1942, there were a total of 31 class I railroads (those having an annual gross income of more than $1 million) in receivership or bankruptcy. These railroads operated 65,395 miles of road. As of June 30, 1953, there were 11 class I railroads in receivership or trusteeship, operating 11,131 miles of road (see exhibit attached.)

There is no reason why this remedial provision should not be made permanent. In the years between 1942 and June 30, 1953, 20 railroads have received the benefit of section 22 (b) (10). Twelve years' experience with this section has demonstrated that it serves a useful purpose. Although as originally enacted the section would have expired December 31, 1945, it has been extended from time to time through the current calendar year. Seldom has the Congress passed so often on the advisability of and need for an isolated provision of law. In the period of its existence, there has been no abuse of this section, nor can there be, for the so-called income constitutes merely the modification or cancellation of a debt which the insolvent corporation is unable to pay. Such modification or cancellation is made with approval not only of the courts but the Interstate Commerce Commission as well. Furthermore, no evasive techniques or loopholes have resulted from the continued existence of this section, which has operated for the benefit of the distressed railroads and to the advantage of the economy in general.

While H. R. 8300 continues this beneficial provision until December 31, 1955, it will be impossible for all of the 11 class I railroads in receivership or trusteeship on June 30, 1953, to have completed their reorganizations by that date. Under some circumstances, the placing of a time limit on a statutory provision is for the purpose of protecting the Government's interest, as well as a prod to those who otherwise might be guilty of laches. In the situation contemplated by section 22 (b) (10) of the code or section 108 (b) of H. R. 8300, there is no room for either purpose. It should be borne in mind that the debtor corporation is ordinarily powerless to prevent delays in the completion of reorganization plans which usually result from a complex corporate structure and a multitude of conflicting interests to be reconciled. The Interstate Commerce Commission and the courts are careful to protect these conflicting interests and afford full opportunity for the presentation of the contentions of all interested parties at each step of the proceeding. The time consumed is in some cases great but

cannot be avoided by any action of the debtor corporation. There is certainly no sound reason why those railroads still in the process of reorganization, or other railroads which may in the future be forced to resort to reorganization, should be deprived of this remedial provision after 1955 which was accorded to those roads whose reorganization was completed prior to that time.

The Missouri Pacific system, including the Gulf Coast Lines and the International-Great Northern Railroad, accounts for 9,294 out of 11,131 miles of road in receivership or trusteeship on June 30, 1953. The Missouri Pacific and its affiliated companies were in trusteeship at the time of the original enactment of this relief provision of law in 1942. Because of the complex nature of its corporate structure and the numerous creditor and stockholder interests involved, it has been impossible as yet to effect a reorganization. Under date of February 17, 1954, Interstate Commerce Commission examiners proposed a modified plan of reorganization, which will now have consideration by the Commission and the courts, with full rights to all creditor and stockholder interests to present their objections and suggestions for modification at every stage of the proceedings. Based on prior experience as to the time required for the carrying out of one of these complex reorganizations of railroad systems, it seems obvious at this date that it will be impossible to complete this reorganization by December 31, 1955.

To permit this provision to expire when any of the 11 railroads now in receivership or trusteeship might still be in the same circumstances would not only reinstate the basic reasons which motivated its enactment in the first place, but would also effect a statutory discrimination within the railroad industry between those roads which had the benefit of the provision and those which, through no fault of their own, would be deprived of its remedial effect. It is submitted that to permit this to happen would be inequitable in the extreme, patently contrary to the very purpose of the proposed tax-revision bill, and definitely prejudicial to the public interest.

In view of the foregoing, the railroad industry urges that section 108 (b) of H. R. 8300 be made permanent. Experience over the last 12 years demonstrates its need and the benefit to all concerned. Short of permanent enactment, this relief provision should certainly be extended to December 31, 1957.

It is, therefore, recommended, in the alternative, that—

1. Section 108 (b) of H. R. 8300 be amended by deleting therefrom the last sentence; or, alternatively,

2. That the last sentence in section 108 (b) of H. R. 8300 be amended by inserting "1957" in lieu of "1954."

SECTION 1017

As previously stated, the purpose of section 108 (b) of H. R. 8300 is to extend the provisions of section 22 (b) (10) without any change in substance. This is shown by the following from page A35 of the report of the Committee on Ways and Means:

"The provisions relating to the discharge of the indebtedness of certain railroad corporations has not been altered in substance, except that the expiration date has been extended for an additional year to December 31, 1955."

Unfortunately, the accomplishment of this announced purpose is prevented by what we believe to be a technical error or oversight in section 1017. It is there provided that where any amount is excluded from gross income under section 108, the taxpayer will be required to make a corresponding reduction in the basis of its assets. By this provision the reduction of basis of property is for the first time made a requirement with respect to any exclusion from income under section 22 (b) (10). It will be remembered that section 22 (b) (10) involves only reorganizations in an equity receivership proceeding or under the National Bankruptcy Act and permits the exclusion of income from discharge or modification of indebtedness in such a proceeding without any corresponding reduction in the basis of the taxpayer's assets. Section 1017 of H. R. 8300 would change this and require such a reduction in basis.

In order to effectuate the announced purpose of the Ways and Means Committee as stated in its report, that is, the mere extension of section 22 (b) (10), it will be necessary for section 1017 to be amended so as to apply only to exclusions from income under section 108 (a) and not to exclusions from income under section 108 (b).

EXHIBIT.—*In receivership*

Railroad	Mar. 31, 1942—Miles of road operated, Dec 31, 1940	June 30, 1953—Miles of road operated, Dec. 31, 1952
Ann Arbor	294	
Georgia & Florida	408	360
Minneapolis & St. Louis	1,409	
Pittsburg, Shawmut & Northern	190	
Rutland	407	
Seaboard Air Line	4,310	
Wisconsin Central	(1)	
Total	7,018	360
IN TRUSTEESHIP		
Akron, Canton & Youngstown	171	
Central of Georgia	1,864	
Central RR. Co of New Jersey	711	
Chicago & North Western	8,319	
Chicago, Indianapolis & Louisville	549	
Chicago, Milwaukee, St. Paul & Pacific	10,854	
Chicago, Rock Island & Pacific	7,900	
Denver & Rio Grande Western	2,566	
Duluth, South Shore & Atlantic	550	
Florida East Coast	685	571
Gulf Coast Lines:		
Beaumont, Sour Lake & Western	146	146
New Orleans, Texas & Mexico	191	196
San Antonio, Uvalde & Gulf	317	317
St. Louis, Brownsville & Mexico	602	596
International-Great Northern	1,155	1,104
Long Island		365
Minneapolis, St. Paul & Sault Ste. Marie	4,267	
Missouri-Illinois	139	
Missouri Pacific	7,146	6,935
New York, New Haven & Hartford	1,853	
New York, Ontario & Western	576	541
New York, Susquehanna & Western	144	
St Louis-San Francisco	4,769	
St. Louis-Southwestern	1,006	
St. Louis-Southwestern of Texas	644	
Western Pacific	1,199	
Wisconsin Central		(1)
Total	58,377	10,771
Grand total	65,395	11,131

[1] Controlled and operated by Minneapolis, St Paul & Sault Ste Marie RR.

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON THE NET OPERATING LOSS DEDUCTION AND THE DIVIDENDS RECEIVED CREDIT

The Internal Revenue Code provides for a deduction from gross income of a net operating loss which may be carried backward or forward within a span of 7 years. The intent of these provisions is to produce the same overall tax on the same taxable income over a period of years for each of the two taxpayers who are similarly situated, except that one may have taxable income in each year of the period, whereas the other may have both income and loss years within the same period.

The Internal Revenue Code permits a corporate taxpayer to take a credit against net income of 85 percent of the amount of the dividends received from a domestic corporation, with the limitation hereinafter noted. A similar provision has been included in each Revenue Act beginning as far back as the Revenue Act of 1917. The purpose of each of these provisions has been to avoid the double taxation of corporate earnings.

Despite the good intention and desirable objective of these two provisions, the fact is that in actual operation their purposes are defeated; double taxation is imposed upon intercorporate earnings, and taxpayers having some loss years and some profit years are made to pay more taxes upon the same aggregate net income than corporations with steady profit years—and this is a result of the purely fortuitous circumstance that a portion of their income is derived from intercorporate dividends.

An attempt to correct this paradoxical situation is made in H. R. 8300, a bill to revise the internal revenue laws of the United States, but the provisions of that bill fall far short of the relief which this situation requires. In order that these specific proposals in H. R. 8300 may be completely understood, it is necessary that they be examined in the light of the application of the present code provisions which they seek to correct.

Under the present law, a corporation includes in gross income 100 percent of dividends received and is entitled to a credit of 85 percent of such dividends, limited, however, to 85 percent of the net income. Therefore, in a loss year, there being no net income, there is no credit for the dividends which were included in gross income. The result in a loss year is to treat dividends as fully taxable income without any offsetting credit. The converse is equally true; in a profit year, since there is net income, the credit can be taken so that in such a circumstance only 15 percent of the dividends included in gross income will be taxed.

For example if each of two corporations (A and B) received $1 million as dividend income in any one taxable year, and if corporation A has a profit in that year whereas corporation B sustains a net operating loss, corporation A is enabled to take its dividends received credit and thereby pay income tax on only 15 percent of its dividends so received, or $78,000. Corporation B, however, is entitled to no dividends received credit by reason of the loss, with the result that it has left in gross income for the loss year 100 percent of its dividends received. It may result from this that in the application of the carryback and carryforward provisions, corporation B will in the end pay up to $520,000 in taxes referable to dividends received in the loss year, as against $78,000 paid by corporation A. It is submitted that no such result can be justified and the exclusion of 85 percent of dividend income from tax should not be dependent upon whether the recipient thereof is in a profit or loss status. It is believed that such anomaly was ever intended. It is clear that it should not continue. This inequitable result should be corrected in simple fashion by converting the present dividends received credit into a fully allowable deduction from gross income.

While the facts assumed above amply illustrate the propriety of converting this credit into a deduction, it should be added that the railroad industry is particularly hard hit by this form of discrimination. In the first place, this industry reflects in a marked degree the peaks and valleys of the economic cycle, with the result that its income in general varies widely from year to year and the fluctuation from income years to loss years is extreme. In the second place it is well known that many railroad systems consist of a number of separate corporations bound together by stock ownership or lease arrangements, or both. For many reasons it is often impossible or impractical to consolidate these various corporations into one company. Since railroads operate through related corporations, in many instances they receive substantial dividends. It should be borne in mind, however, that the income which produced these dividends has already been fully taxed.

The illogical and inequitable result from the interplay of the net operating loss and dividends received credit provisions of existing law in a loss year is clear. However, this is but half the story. A further discrimination arises when a corporate taxpayer which has suffered a loss (and therefore has to treat as fully taxable income the dividends received in that year) attempts to carry that loss forward or backward as a deduction from the income of a profit year. Under the existing law, if the income of the profit year included dividend income, the amount of the loss being carried forward or backward is required to be reduced by the amount of the dividends received credit in the profit year. In other words, the dividends received credit is denied, not once, but twice.

The sum and substance of this is that a corporation in a loss year is deprived of its dividends received credit while its gross income includes 100 percent of its dividends. In carrying its loss forward or backward to the profit year, the loss must be further reduced by the dividends received credit allowed in the profit year to which the loss is carried. Thus, the interplay of the net operating loss and dividends received credit provisions of the code is to reduce the loss, not only in the year of the loss, but also in the year to which it is carried, by the amount of the dividends received credit of each year. This renders the loss carryover provisions useless to a corporation receiving dividends, unless the loss exceeds the dividends received in both the year of the loss and the year to which the loss is carried forward.

To illustrate the discriminatory nature of the present statutory provision, assume that corporation A has a net income of $10 million in each of 2 consecu-

tive years, while its competitor, corporation B, has fluctuating income which aggregates the same $20 million but which is represented by a loss of $10 million in the first year and net income of $30 million in the succeeding year, so that over the 2-year period each corporation has $20 million net income. Assume further that each company receives sufficient dividends annually which, but for the limitations imposed by the code, would produce a dividend received credit of $5 million. Under the present statutory provisions, and assuming a 50-percent rate, Corporation A will pay taxes of $5 million for the 2 years involved, while Corporation B will pay taxes of $10 million, or 100 percent more, simply because it had a combination of loss and profit years. This is so because corporation B not only loses its $5 million dividends received credit in the year of the loss, but it is also required to reduce the loss carryover by the $5 million dividend received credit in the year to which the loss is carried. (See exhibit, which shows this in detail.)

Thus we have the anomalous situation wherein each of 2 corporations has $20 million net income for the same 2-year period, and 1 corporation pays 100 percent more in tax than the other. Certainly, such a discriminatory and inequitable result was never intended. It should not be permitted to continue. This situation can be corrected by converting the dividends received credit into a dividends received deduction without imposing any limitations thereon.

The Ways and Means Committee in its report on H. R. 8300, at page 27, stated:

"Your committee has also made changes in the method of computing the net operating loss deduction, in order to lessen the differences in tax treatment of firms with fluctuating and those with stable incomes. Under present law the loss is reduced for certain items with respect both to the loss year and the income year to which the loss is carried, before the loss can be offset against taxable income of the latter year. Thus under existing law taxpayers with loss carryovers are denied the use of tax benefits which are fully available to those with stable incomes."

Thus the Ways and Means Committee clearly recognizes the discrimination which exists between the taxpayer with fluctuating income and the taxpayer with steady income years. Certainly this recognized discrimination should be eliminated insofar as it relates to dividends which have already been taxed once. This results in double taxation of dividend income.

While H. R. 8300 changes the credit for dividends received to a deduction for dividends received (sec. 243 (a)), the bill also limits the amount of the deduction to 85 percent of taxable income (sec. 246 (b)). The effect is the same as the credit provision of the existing law and consequently the deduction under H. R. 8300 in a loss year is zero. There has been a change in language with no change in effect. Furthermore, except for the first year to which the loss may be carried, the balance of the loss to be carried to a profit year must be reduced by 85 percent of the dividends received in the prior year. Here again, we have exactly the same discrimination that exists under present law, except in the simple instance where the net operating loss deduction can be completely absorbed in the first year to which the carryover is taken.

It is submitted that the profit or loss status of a corporate taxpayer should not determine whether it is entitled to a deduction. If dividend income is to be deducted to the extent of 85 percent in profit years, it is patently clear that it should be similarly treated in loss years.

To recognize the paradox in the application of these provisions of existing law and to attempt only the very limited correction proposed is both illogical and unsound. On page 27 of the committee report accompanying H. R. 8300, it is stated that the Ways and Means Committee changed the method of computing the net operating loss deduction "in order to lessen the difference in tax treatment of firms with fluctuating and those with stable incomes." These differences should be eliminated, not "lessened," and this could be accomplished by deleting from section 172 (d) (5) the provision which precludes the deduction of 85 percent of the dividends received in determining the net operating loss and eliminating the limitation on such deduction appearing in section 246 (b).

This matter of the full availability of a net operating loss deduction is now even more important than ever. With the existing high tax rates the availability of a loss carryforward or carryback is essential. No business with fluctuating income years can hope to exist for any great length of time unless there is available some method of averaging its income for an extended period of years. This was recognized by H. R. 8300, since it provided for a 2-year carryback instead of the existing 1-year provision, thus providing for an 8-year spread. Corporations

with dividend income should not be denied the same privilege; nevertheless such is the case under H. R. 8300.

The net operating loss provisions can and should provide a strong economic incentive during periods of decreased business activity. With assurance that any loss which may be sustained will be offset against profits of another year, a corporation can continue to make expenditures for maintenance and improvement of its plant and to keep employment at a high level. However, where a corporation is effectively denied the availability of these provisions, it may be forced to curtail such expenditures at a time when it will do the country the most harm. This is particularly true when we are dealing with the railroad industry, which is considering a capital investment in 1954 of approximately $1 billion, which is about 25 percent under the average of the last 5 years.

The railroad industry is the key to our national defense program. Our entire defense system is predicated upon an adequate transportation system in this country. Our tax system certainly should not be geared so as to deter the development of the most efficient system possible. Yet, by deterring the making of the capital expenditures required to modernize, expand, and improve our railroad systems, just that unfortunate result is attained.

In view of the foregoing, it is submitted that——

1. The dividends received credit under existing law should be converted into a deduction for all purposes without limitation;

2. The deduction for dividends received as authorized by H. R. 8300 should not be dependent upon the profit or loss status of the recipient of such dividends.

The accomplishment of the first submission would necessitate the following amendments to the Internal Revenue Code:

Add to section 23 of the code the following new subsection:

"(gg) DEDUCTION FOR DIVIDENDS RECEIVED BY A CORPORATION.—In the case of a corporation, 85 per centum of the amount received as dividends (other than dividends described in section 26 (b) on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter."

Section 26 (b) should be amended technically to remove the present subsection (1) which now allows a credit for dividends received from domestic corporations. Also, section 433 (a) (1) (A) should be amended to allow an adjustment, without limitation, for the new dividends received deduction.

To accomplish the second submission, H. R. 8300 should be amended as follows:

Amend section 172 (d) (5) to read:

"(5) SPECIAL DEDUCTION FOR CORPORATION.—No deduction shall be allowed under Part VIII (except sections 243 (a) and 248) or under section 922 (relating to Western Hemisphere trade corporations)."

Amend section 246 (b) by deleting therefrom the first reference to section 243.

EXHIBIT

[In millions]

	1st year	2d year	Total, 2 years
Corporation A:			
Net income	$10	$10	$20
Dividends received credit	5	5	10
Normal tax net income	5	5	10
Tax at 50 percent	2.5	2.5	5
Corporation B			
Net income	−10	[1] 30	20
Net operating loss	10	-------	10
Net operating loss deduction	-------	[2] 5	5
Dividends received credit	[3] 0	5	5
Normal tax net income	-------	20	20
Tax at 50 percent	-------	10	10

[1] Prior to net operating loss deduction.
[2] Net operating loss of $10 million as reduced by dividends received credit of second year ($5 million). IRC section 122 (c).
[3] Despite receipt of dividend income, the dividends received credit is not available in loss year. IRC section 26 (b).

STATEMENT OF ASSOCIATION OF AMERICAN RAILROADS ON CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

In order to avoid a discriminatory result it is necessary that the effective date provision of section 391 of H. R. 8300 be modified, as hereinafter explained.

Under existing law in the case of a reorganization which may qualify as a "statutory merger or consolidation," as defined in section 112 (g) (1) (A) of the Internal Revenue Code, the courts and the Commissioner have held that under the theory of continuity of corporate interest and fusion of assets and liabilities by operation of law, the continuing or successor corporation should be granted the deductions, credits, or other allowances to which its predecessor would have been entitled had it continued its separate existence.

When a taxpayer attempts to use some of the other provisions of section 112 (g) (1) such as "(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, for at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation," or "(F) a mere change in identity, form, or place of organization, however effected" the Commissioner and the courts have denied the continuing corporation the benefit of the tax privileges of the transferor.

Section 381 of H. R. 8300 headed "Carryovers in Certain Corporate Acquisitions" eliminates the inequities resulting from relying upon the artificial form of reorganizations instead of economic realities. That such is the purpose of this section is indicated by the following quotation from the House report on H. R. 8300 (H. Rept. 1337), which states, at page 41, that:

"Present law makes no provision for the transfer from one corporation to another in a tax-free merger or consolidation, of the major tax benefits, privileges, elective rights and obligations which were available to the predecessor. These include such items as loss carryovers, unamortized bond discount, installment sales reporting, Life inventory methods, etc. The courts have held, in general, that such tax attributes of a corporation may be preserved only by continuing the corporation's identity. For example, the surviving corporation in a merger is generally entitled only to the tax attributes from its own premerger experience and not from the experience of the other corporations merged. More recently, however, this separate entity rule appears not to have been followed.

"As a result, present practice rests on court-made law which is uncertain and frequently contradictory. *Moreover, whether or not the carryover is allowed should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization.* [Italics supplied.]

"The bill provides for the carryover of about 16 specific tax attributes or items from one corporation to another in certain tax-free reorganizations. Under this provision, a corporation which acquires substantially all the property of another corporation in a tax-free transfer is to take into its accounts certain specified items of the distributor or transferor corporation. The principal items are loss carryovers, earnings and profits, and certain elections, such as those relating to LIFO inventory accounting and those relating to the use of the special declining balance depreciation method. No provision is made for the apportionment of such items in the case of split-ups, spin-offs, or other divisive reorganizations."

The proponents of this bill, mindful of the economic realities involved, have defined, in section 359 (c), "a corporate acquisition of property" as the acquisition by one corporation, whether or not by statutory merger or consolidation, of at least 80 percent of the fair market value of the properties of another corporation less liabilities solely in exchange for all or part of its participating stock subject to certain conditions. Because this definition is not limited to a statutory merger or consolidation and since section 381 provides that in the case of such a tax-free corporate acquisition of property, the acquiring corporation shall succeed to and take into account certain deductions and other items of the predecessor corporation, it would appear that the ends of economic reality were fully attained.

However, section 391 of H R. 8300 provides that the right to carry over these tax benefits to an acquiring corporation in a tax-free reorganization shall be effective only with respect to distributions or transfers occurring after March 1, 1954.

The House report states on pages 40 and 41: "The determination of the tax treatment of transactions of the types described in subchapter C of the bill

carried out prior to the effective date thereof is to be made as if the bill had not been enacted and without inference drawn from the fact that the amendments made therein are not made expressly applicable to prior taxable years in which transactions of these types may have been effected."

Using economic realities as the test instead of artificialities of form, H. R. 8300 has made definite in section 381 the right of a continuing or transferee corporation in a tax-free reorganization or liquidation to deductions, credits or allowances. However, because section 381 is to be effective only with respect to distributions or transfers occurring after March 1, 1954, it necessarily follows that in otherwise identical circumstances, deductions may be allowed to one corporaate taxpayer but disallowed as to another, depending on whether the distribution occurs before or after this date. For example: In order to change its state of incorporation (for legitimate business reasons), a corporation acquires all the assets and liabilities of another corporation and continues its business under a ruling of the Internal Revenue Service that the acquisition results in a tax-free reorganization under the Intetnal Revenue Code. The stockholders of the acquiring corporation are exactly the same as those of the transferring corporation. Prior to March 1, 1954, corporation A followed the above procedure. Subsequent to March 1, 1954, corporation B does exactly the same thing which corporation A did prior to that date.

Should this effective date provision be enacted as set forth in section 391 of the bill, there is doubt if corporation A would be entitled to the deductions of its predecessor corporation for its right to any such deductions would have to be decided pursuant to the existing confused state of the law which H. R. 8300 is intended to correct. However, there would be no doubt as to the right of corporation B to succeed to its predecessor's tax privileges.

It is realized that statutory provisions must have effective dates. However, the effective date of this provision is related to the time when a distribution or transfer is made rather than to a particular taxable year. The result is that in a tax year subsequent to the date in which H. R. 8300 may become law the same deductions for taxpayers identically situated will be treated differently depending upon whether a distribution or transfer was made before or after March 1, 1954. To illustrate and as stated above, corporation A and corporation B had identical reorganizations except for the dates. In each case there were carryover items for amortization of bond discount. In their respective tax returns for the taxable year 1955 (after the enactment of H. R. 8300) corporation A would not have the benefit of carrying over its predecessor's deductions because it had concluded its reorganization before March 1, 1954, whereas corporation B would be so entitled.

As a consequence of the proposed effective date, corporation may be taxed by reason of a tax-free reorganization on an item which would have been deductible to its predecessor. In the example given, although corporation A assumed all of the liabilities and obligations of its predecessor, the deduction for bond discount is lost forever. It may never be taken by any taxpayer. This is clearly a tax imposed by reason of a reorganization which under the law is mistakenly referred to as tax-free. It is difficult to conceive that such a result was intended by the proponents of this bill who so clearly recognized the economic realities involved.

It is, therefore, submitted that while section 381 seeks to provide relief from inequities and confusion, by reason of its effective date it results in different treatment to identical taxpayers within a single tax year, which is unfair, inequitable and discriminatory. Consequently, it is proposed that section 391 be modified so that the carryovers specified in section 381 be allowed in all open tax years or, alternatively, in all tax years ending after March 1, 1954, regardless of when the transfer or distribution occurred.

Adoption of the proposed amendment would afford taxpayers uniformity of tax treatment of rights and privileges in legitimate recognized business reorganizations; and the Commissioner and the courts, as well as the taxpayers, would be saved useless litigation arising from legalistic distinctions.

[H. R. 8300, 83d Cong., 2d sess]

AMENDMENT

Intended to be proposed by Mr. Kerr (for himself and Mrs. Smith of Maine) to the bill (H. R. 8300) to revise the internal revenue laws of the United States, viz: On page 55 and 56, strike out section 214 and insert the following:

SEC. 214. EXPENSES FOR CARE OF CERTAIN DEPENDENTS

(a) GENERAL RULE.—There shall be allowed as a deduction expenses paid or incurred during the taxable year by the taxpayer for the care of one or more dependents (as defined in subsection (c)) if such expenses are necessarily incurred because the taxpayer, who could otherwise render such care personally, is gainfully employed.

(b) LIMITATION.—The deduction under subsection (a) shall not exceed $600 of expenses paid or incurred during the taxable year for all dependents of the taxpayer.

(c) DEFINITIONS.—For purposes of this section—

(1) DEPENDENT.—The term "dependent" means a person, with respect to whom the taxpayer is entitled to an exemption under section 151 (e) (1), who is—

(A) a child under the age of fourteen years, or

(B) a child over the age of fourteen years but physically or mentally incapable of caring for himself, or

(C) an infirm or incompetent person.

(2) CARE.—The term "care" includes the feeding, supervision, and attending of a dependent.

The CHAIRMAN. At the request of Senator Kerr, who is in Oklahoma today, I submit for the record a statement by Miss Mary Quinn, in behalf of the Oklahoma Federation of Business and Professional Women's Clubs, Tulsa, Okla., endorsing the Kerr-Smith amendment to H. R. 8300, to extend the proposed deduction for child-care expenses up to $600 to all taxpayers alike.

(The statement referred to follows:)

OKLAHOMA FEDERATION OF
BUSINESS AND PROFESSIONAL WOMEN'S CLUBS,
Tulsa, Okla., April 22, 1954.

To the Honorable Members of the Senate Finance Committee:

Realizing the importance, to a large number of taxpayers, of the matters now being considered by your committee in connection with H. R. 8300; and realizing also the vast amount of work before you, we shall be as brief as possible in stating our reasons for supporting wholeheartedly, and urging passage of the Kerr-Smith amendment to that portion of H. R. 8300 having to do with dependency are allowances.

We subscribe to the principle of the allowance provided in H. R. 8300 to employed widows, widowers, legally divorced or separated persons, for the care of their own children, but respectfully call to your attention that the application of this principle is limited to certain specified groups of taxpayers, whereas certain other groups with the identical basic problem have been excluded.

Those who are excluded are: (1) taxpayers other than widows, widowers, legally divorced or separated persons, having the care of their own children; (2) taxpayers—married and single, men as well as women—having the care of children not their own but who qualify as the taxpayer's dependents under the present Federal income-tax code; (3) taxpayers having the care of infirm or incompetent adult dependents, who are incapable of self-care, the same as children, but whose care is not accepted by the Internal Revenue Department as a medical deduction.

The public in general has become extremely tax-conscious, and that is good. H. R. 8300 is recognized as a much needed tax structure reform bill. The majority of the proposals contained in the bill have been born of the experience of millions of taxpayers whose needs, taxwise, have gone unrecognized for many years. However, with regard to this section, the reform is too restricted for equitable treatment of taxpayers with the same dependency care problem.

Having been engaged in the study of this problem for well over a year, we feel justified in our belief that that section of H. R. 8300 dealing with dependency care allowances in its present form presents a situation which you, as representatives of all taxpayers, must agree needs correction. The Kerr-Smith amendment will accomplish this purpose.

Respectfully,

MARY QUINN, *Chairman.*

The CHAIRMAN. Mr. Dawson, please.

STATEMENT OF JOHN S. DAWSON, OF THE BRIDGEPORT BRASS CO.

Mr. DAWSON. Good morning, Mr. Chairman and members of the committee.

We appreciate the opportunity this morning of telling the committee of the need for a technical amendment to some of the LIFO inventory replacement provisions contained in section 1321 of the House bill.

I would like to have the privilege of asking that our prepared statement be included in the record.

The CHAIRMAN. We will include it in the record.

Mr. DAWSON. And I would like to take a few moments of the committee's time to give you the highlights of the purpose of this amendment.

The purpose of the amendment is to restore LIFO inventory replacement rights, which were inadvertently and unfairly taken away from certain of the smaller independent brass mills. The amendment is necessary to give these companies the same treatment as their more powerful integrated competitors, who are now enjoying the protection which the LIFO replacement provisions afford from the tax penalties which resulted from the Government stockpiling of metals, which occurred during the early part of the war in Korea.

This company and others similarly situated, were prevented from using this inventory replacement provision, by a peculiar legislative quirk contained in section 459 (f) of the code.

I would like to describe briefly how LIFO works, and what the quirk is, Mr. Chairman. We are an old company, an 88-year-old independent brass mill. During the last 15 years, under the leadership of Herman W. Steinkraus, our present president, we have grown very substantially.

More recently, we have expanded into the aluminum business.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Mr. DAWSON. In our brass mills we take virgin copper and zinc and scrap containing these metals, and alloy them into brass and copper mixtures, which we form into various shapes, such as sheet, rod, and tube.

The prices of the raw materials, the copper and zinc, as the committee may know, tend to fluctuate up and down. So the members of our industry have almost universally adopted the LIFO method of inventory valuation. As the members of the committee well know, the objectives of this method of accounting is to prevent artificial inventory profits and losses and thus afford more stable margins.

The LIFO system is premised on maintaining relatively stable base-inventory levels. When there is a liquidation of inventories below these basic levels, a fictitious metal profit results. This ordinarily

results in artificially increased taxes. That is what happened after the outbreak of the war in 1950, as a result of copper stockpiling, when current raw material replacement costs were much higher than the prices in effect when most of the companies adopted the LIFO system.

In 1951, Congress recognized what had taken place, and wisely adopted section 22 (d) (6) (F) of the code, to permit companies on the LIFO basis, whose taxes were thus inflated by involuntary liquidation brought on by the dislocations of the Korean war, to replace these inventories up to January 1, 1956. The House, in section 1321 of H. R. 8300 is extending that principle to cover liquidations which occur right up to the beginning of next year.

Now, copper stockpiling by the Government severely arrested our company's growth, and in the last part of 1950, after the Korean war began, the physical output of both our company and the industry fell below the rate that we had reached in the pre-Korean quarter, in the second quarter of 1950. This is in marked contrast to the steel as well as many other segments of industry.

In my prepared statement I have included an exhibit which very graphically shows how copper stocks, both in the hands of refiners and in the hands of the fabricators, fell to a record low, Mr. Chairman.

Now, this shortage of copper forced our company, as well as all other copper fabricators, to dip severely into their inventories. So, the people in our industry needed the LIFO provisions to get a fair base for their taxes. We, and practically everybody else, so far as we know, in our industry elected to take the benefit of these replacement provisions.

Now, in1952 this committee very courteously tried to help growing companies like us, who are independents in the brass mill industry, by means of an excess profits tax amendment, section 459 (f) of the Internal Revenue Code. But a quirk in that section inadvertently denied us the benefit of the LIFO replacement provisions because to use them would have meant a big increase in our excess profits taxes—a much larger increase in excess profits taxes than we would have gotten in LIFO benefits under the sections we are discussing here.

And why was that? It was because the year 1950 was made the key to our excess profits tax credit. 1950 was the year when the liquidation in copper occurred—when we had to live off our inventory. That was the year that was to be reconstructed under LIFO by all of our competitors but which reconstruction is denied us.

A very simple correction can take care of this situation. The correction would permit this company and others like it to make the LIFO election and provide that the LIFO recomputation would not affect our present excess profits tax credit.

We have discussed this with the staff and we would be glad to cooperate with the staff in the development of such a simple amendment. Such a correction would mean no actual revenue loss to the Government on the LIFO theory that this would equal out over a period of time, because the erroneous 1950 taxes collected were based on fictitious profits of these companies and clearly could not have been reflected in budget estimates.

We have submitted in the detailed appendix the reason why the credit developed for this company under section 459 (f) was totally inadequate and failed to accomplish its purpose, which was to give a

fair excess profits tax credit to the company. We are proposing here to let that alone and to try to make provision for companies in our situation to have the benefits of LIFO, like almost everybody else in the metals industry. We feel that the skills, the facilities, and the resources of independent growing companies in the metal fabricating business are of increasingly vital importance in this atomic-air age. The survival of our country and the free world may well depend upon our country staying in the forefront of metal developments and advancement. So, we feel that the continued strength of independent fabricators like ourselves is important to our national interest.

We know that the members of this committee have always been interested in correcting patent inequities and we think justice in this case calls for that simple correction.

Senator BUTLER. Just one question: You made a statement that the proposal that you suggest would represent no loss of income to the Government, because it would level out.

Mr. DAWSON. That is the theory behind LIFO.

Senator BUTLER. If that was the case, and no change was made, it would level out just the same for the taxpayer.

Mr. DAWSON. The trouble is, Senator, we are on LIFO and, since we get only a part of the benefit it is like taking an apple and having part of it removed. If we were on some different system of accounting than LIFO, then what you say would be perfectly true, Senator. But in LIFO if we have part of it, we ought to be able to avail ourselves of the remainder of the provisions of the system.

The CHAIRMAN. Any further questions?

Senator BUTLER. No.

The CHAIRMAN. Thank you very much.

Mr. DAWSON. Thank you.

(The statement of Mr. Dawson follows:)

BRIDGEPORT BRASS CO.
Bridgeport, Conn., April 22, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: We appreciate this opportunity of telling the Committee on Finance of the urgent need for a technical amendment to the LIFO (last in, first out) replacement provisions contained in section 1321 of H. R. 8300.

The purpose of such an amendment is to restore LIFO replacement rights unfairly and inadvertently taken away from certain smaller independent brass mills. The amendment is necessary to afford these companies the same treatment as their powerful integrated competitors. These competitors are now enjoying the correction which LIFO replacement provisions afforded from the tax penalties occasioned by Government stockpiling of strategic metals during the early part of the Korean war. This company and others similarly situated were prevented from using the replacement provisions by a legislative quirk contained in section 459 (f) of the code.

Copper stockpiling by the Government in 1950 arrested this company's growth in that year since it placed copper in very short supply. In the last half of 1950 after the war in Korea began, physical output of both the company and the brass-mill industry fell below the rate attained in the second quarter of 1950—in marked contrast to the experience of other segments of industry. The extent of the copper scarcity may be shown by exhibit 1 which plots stocks of refined copper over a number of years. This shows that at the end of 1950 stocks of copper in the hands of smelters and refiners and of fabricators were at a record low.

This shortage of copper forced our company, as well as other copper fabricators, to dip severely into their inventories in 1950.

The objective of the LIFO method of accounting is to use current raw-material costs against current sales prices—thus affording stable margins and preventing fictitious metal profits and losses. It is premised upon maintaining steady basic inventory levels. Liquidation of inventories below these basic levels—as occurred after the outbreak of the Korean war in 1950, at a time when current raw-material costs were much higher than levels in effect when companies in our industry adopted LIFO—results in substantial but fictitious metal profits being reflected in artificially increased taxes.

In 1951 Congress wisely adopted what became section 22 (d) (6) (F) of the code to permit companies on a LIFO accounting basis, whose taxes were thus inflated by involuntary liquidation of inventories brought on by dislocation from the Korean war including stockpiling, to replace inventory up to January 1, 1956.

The principle of section 22 (d) (6) (F) has been extended by the House in section 1321 of H. R. 8300 so that inventory liquidations through the year 1954 may be replaced as late as December 31, 1955.

This company, like almost all others in the metals industries, was on the LIFO method of accounting for the year 1950. The reasons which led to the enactment of the replacement provision in 1951 apply equally to this company as to all others in the metals industry. However, the impact of the 1950 liquidation was particularly severe on a growing company like ours, whose allocations of metal were based on an inadequate base period. For us to maintain our relative tax situation in a highly competitive industry, it was imperative that we elect to replace LIFO inventories under section 22 (d) (6) (F), and we did so.

At its last meeting in June 1952, this committee reported out what is now section 459 (f) of the Internal Revenue Code in an effort to provide sorely needed excess-profits-tax relief to smaller independent companies in the brass-mill industry. The formula contained in this law was designed to correct a squeeze in brass-mill margins during the base period and to give recognition to a substantial increase in capacity during the same period. The formula originally proposed was modified shortly before this committee's action so that 1950 became the key to the excess-profits-tax credit under this provision. This has had an unforeseen and unintended result. This company, in December of 1952, was forced to rescind its election to replace under section 22 (d) (6) (F) because replacement under the provisions of the code would have operated to increase its excess-profits taxes more than the amount saved in recomputing its taxes under the LIFO replacement provisions.

If this company had continued its election to replace the 1950 inventory under section 22 (d) (6) (F) it would have reduced 1950 earnings not only for the purpose of making the LIFO adjustment under that section, but also for the purpose of computing its excess-profits tax credit under section 459 (f) for each of the years 1950 through 1953.

We respectfully suggest that this unintended discrimination against smaller independent brass companies can be easily corrected by a simple amendment to section 1321 of the House bill, which would permit this company and others like it to make the LIFO election for 1950 and provide that the recomputation of the net income for the year 1950 for LIFO purposes shall not affect the company's excess-profits tax credit. We should be glad to cooperate with the staff of the committee in the development of such an amendment.

This correction would mean no actual revenue loss to the Government, since the erroneous 1950 taxes collected were based on fictitious profits of these companies and clearly could not have been reflected in budget estimates.

Such a LIFO amendment would not correct the basic inadequacy of the excess-profits tax credit afforded to the smaller independent brass companies by section 459 (f).

We are submitting as an appendix hereto for the record for any future action that the Congress may see fit to take, reasons why the credit developed for this company under section 459 (f) failed to give effect to the purpose for which it was enacted, i. e., to give a fair excess-profits tax credit to this company and others like it.

Because of its growth in the years 1946 to 1950, our 88-year-old independent metal company has been severely handicapped by the Government in at least four important respects:

1. Unfair excess-profits taxes drained off cash badly needed for continued expansion;
2. As a result of the copper and zinc shortage aggravated by Government stockpiling, certificates of necessity were denied brass mill companies generally;
3. The metal allocation system based on an unfair base period gave us metal supplies inadequate for our expanded needs;
4. The crowning blow was the technical LIFO error we have here described; this caused us to suffer a competitive tax disadvantage not inflicted on our larger competitors.

The skills, facilities, and resources of independent metal fabricators in this atomic-air age are becoming of increasingly vital importance to our country and the free world. The measure of our advances in metals may well be the measure of our strength. The maintenance and continued growth of vigorous independent metal fabricators such as this company are thus vital to the national interest.

Members of this committee have always been interested in correcting inequities of this sort.

Basic justice calls for correction.

Respectfully submitted.

JOHN S. DAWSON,
Vice President and Secretary.

APPENDIX A

SECTION 459 (F) FAILS TO GIVE EFFECT TO THE INTENT OF CONGRESS

We are setting forth in this appendix the inadequacy of the excess-profits tax credit of this company under section 459 (f), which was enacted for the purpose of giving a fair measure of normal earnings for this company and others like it. This credit was far too low by any standard—even before the reduction which would have come from the application of the LIFO replacement provisions discussed in the foregoing letter.

In the event Congress should undertake to correct the most glaring inequities under the excess-profits tax, either in this session of Congress or later, first consideration should be given to cases of this type as a matter of unfinished business.

WE ARE A GROWTH COMPANY

Bridgeport Brass Co. has grown into a vigorous, expanding company, the largest independent in the brass mill industry. It has been built on the foundations of a fine 88-year-old company, which for many years did no business further west than Buffalo and concentrated in New England and the Northeast.

In 1928, under the leadership of Herman W. Steinkraus, now its president, the company began to expand its sales activities on a national basis, and in the early thirties changed over from a family company to one now owned by some 10,000 stockholders. Today, the company has 6 plants, 3 plants at Bridgeport, Conn., a large mill at Indianapolis, Ind., with basic capacity equal to that of the Bridgeport mills, a small foundry at Exeter, N. H., and a large aluminum extrusion and forging plant recently leased at Adrian, Mich.

We also have numerous warehouses and district offices located across the country so that we can give prompt service to the technical requirements of our customers.

Our organization has grown to some 5,000 employees, which in our mind have always been the most important part of our company. We have never had a strike. The teamwork and cooperation of our organization is getting better all the time. Our current payrolls are approaching $25 million annually.

We make and sell a complete line of brass mill products in the form of sheet, rod, wire and tube, which have a very wide range of use—wider even than that of steel. In addition, we make fabricated products such as plumbing goods, tire valves, and aerosol pressure-packaged products.

We are still growing. The year 1954 will see expansion into volume production and sale of aluminum mill products such as extrusions, forgings, and tubing.

MOST OF GROWTH SINCE 1938

The company's major growth has occurred since 1938 when it completed at Bridgeport the first continuous rolling mill in the brass industry. Since that year, our sales have increased over 10 times and our assets have increased fivefold.

FACILITIES DOUBLED IN 1946-48

Adjusted facilities in the base period more than doubled from the beginning of 1946 through 1948 (from $7,213,000 to $14,723,000), as shown by exhibit 2. Since the end of World War II, the company has had a vigorous growth. It modernized its older plants in New England. It developed the new Indianapolis plant acquired in July 1948. Consequently, sales grew from $57,236,000 in 1946 to $142,659,000 in 1953. Yet, in this same period, the brass mill industry was doing poorly as compared with iron and steel, durable manufacturers, and total manufacturers as shown by exhibit 3.

These new postwar facilities, along with the requisite additional working capital, were financed through retained earnings supplemented by some $13 million of long-term debt. The company had no public common stock financing between 1937 and November 1953.

PROFITS IN 1947, 1948, AND 1949 RETARDED BY TWO FACTORS

The company's growth in profits since 1946 did not parallel its sales growth, as is shown by exhibit 2, because profits were retarded by two factors.

1. A squeeze in brass mill margins took place during 1947, 1948, and 1949 because of an unusual discrepancy between the costs of copper and the prices of brass mill products.

2. Normal profits from the Indianapolis plant could not be attained during the base period since the plant was acquired late in the base period in July 1948. In our industry, training an organization is especially long and costly. At Indianapolis we had to train some 1,500 men at a cost estimated to exceed $1,500 per man.

PROFITS DOUBLED SINCE 1950

Profits before taxes began early in 1950 to reflect a growth of over 100 percent in adjusted facilities during 1946, 1947, and 1948. Since 1950, with gradual realization upon increased capacity, profits have developed steadily to the point where in 1953 they were twice 1950 levels. The fact that the company's earnings during the last 4 years came from its expansion during the years 1946-48 is clearly shown by the fact that the company spent less than the amount of its depreciation on capital expenditures for plants and equipment during the years 1949, 1950, and 1951. In the latter part of 1952 we again stepped up expenditures for facilities but these expenditures did not make significant contributions to earnings before 1954. Since the end of World War II we have reduced break-even points significantly, and for the year 1953 a profit improvement program for our whole organization advanced the profit levels of our business.

CONGRESS HAS TRIED TO GIVE US EXCESS PROFITS TAX RELIEF

During the hearings in 1950 on the Excess Profits Tax Act, this company presented testimony before the Ways and Means Committee and your Finance Committee to the effect that base period earnings would be no fair measure of the company's normal earnings.

In 1951, a further statement was presented to your Senate Finance Committee but no remedial action was taken at that session.

In 1952, however, an amendment reported out by your Senate Finance Committee was accepted by the House conferees, and was enacted as section 459 (f) of the code. For the benefit of smaller independent companies in the brass mill industry, this section was designed to correct the squeeze in brass mill margins and to give recognition to a substantial increase in capacity during the base period.

In 1953, we made a statement to the House Ways and Means Committee on the unintended inadequacies of section 459 (f), but no relief amendments were adopted by Congress when it extended the excess-profits tax.

SECTION 459 (F) FAILED TO GIVE EFFECT TO THE INTENT OF CONGRESS

The intent of Congress in enacting section 459 (f) was nullified by inserting at the last minute a miscalculated limitation in the formula just before the last meeting of your Finance Committee in 1952. This quirk was impossible for anyone to assess accurately in the closing moments of that session. Several unforeseen and unintended results occurred. As we showed in the accompanying letter, the company was forced to abandon its right to LIFO replacement.

In addition, the section 459 (f) formula gives no credit for the Indianapolis plant.

The Indianapolis plant acquired on July 1, 1948, late in the base period, had no chance to develop its normal earnings by 1950. The earning capacity of this plant, however, is at least as great as that of the company's Bridgeport mills; its physical capacity is basically as large and its efficiency is greater. In 1952, its earnings passed, and in 1953, substantially exceeded those of the Bridgeport mills.

Exhibits 4 and 5 dramatically show the inadequacy of the "average base period net income" (ABPNI) developed for the company under section 459 (f). This ABPNI is only 56 percent of the company's minimum normal earnings[1] as shown by exhibit 4. Using the test of the experience of all corporations in the second quarter of 1950, it is barely adequate to measure the company's minimum normal operations, exclusive of Indianapolis. Exhibit 5 shows that the company ABPNI under section 459 (f) is a totally inadequate 38.3 percent of 1953 earnings, little more than half the proportion for all corporations.

The normal earning power of the Indianapolis plant could not be realized for some time after the acquisition of this plant on July 1, 1948. Many shifts of equipment and costly training or organization had to occur before the plant could operate profitably as a complete unit for making commercial sheet, rod and tube for the midwest market. It is only recently that this plant has approached its normal earning capacity. Its earnings in 1950 were only 15.9 percent of the company's net operating income for that year, but they rose to 27.2 percent in 1951, to 46.3 percent in 1952, and reached 60 percent in 1953.

The profit growth at this plant was attributable not only to the increased sales, but to its improved efficiency. The 1952 and 1953 performance of the Indianapolis plant more than justified our original confidence that it had an earning capacity at least equal to that of the Bridgeport mills. The dramatic growth of our Indianapolis plant is further illustrated in exhibit 6, which plots the net profits of the Indianapolis plant, those of the company without Indianapolis, and those of all corporations for each quarter of 1950 (at annual rates), and for the years 1951, 1952, and 1953. This exhibit shows that our company's non-Indianapolis operations stayed relatively close to the results obtained by all corporations. Indianapolis, on the other hand, pulled way up. Any formula using this company's 1950 earnings would fail to give a fair measure for the Indianapolis earning power.

COMPANY HAS SUFFERED COMPETITIVE TAX DISADVANTAGE

The failure of section 459 (f) to relieve this company is clearly shown by exhibit 7 which measures the tax bite in the case of (*a*) this company; (*b*) all corporations; and (*c*) four large, integrated copper corporations with which the company competes in the sale of brass mill products. This exhibit shows that the company's effective tax rate (62.7 percent) in 1951 was 6.2 percentage points higher than that of all corporations (56.5 percent), and almost 12 percentage points higher than that of its powerful integrated copper competitors (50.8 percent). Its rate rose to 66.8 percent in 1952, when it was over 14 percentage points higher than that of all corporations (52.6 percent) and 18.4 percentage points higher than that of its copper competitors (48.4 percent). In 1953, its rate reached the maximum of 70 percent and thus soared 15.4 percentage points above all corporations (54.6 percent), and 19.1 percentage points above its copper competitors (50.9 percent).

WE STILL URGENTLY NEED EXCESS PROFITS TAX RELIEF

It would be an easy matter to develop a simple amendment eliminating 1950 from the formula of section 459 (f) which would give full effect to the intent of Congress by providing a fair measure of normal earnings for the company's expanded facilities. We have reviewed with the staff on a number of occasions technical data which establish the fairness of such a revised formula.

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[1] As reflected by rates of earnings reached in the second quarter of 1950. Actual rates of earnings are used for all operations outside of Indianapolis, and the earnings rate of Bridgeport mills is used for Indianapolis.

The company's ABPNI under sec. 459 (f) was 96 percent of its earnings rate, exclusive of Indianapolis, in the second quarter of 1950. It is significant that this ratio is in line with the ratio of 90 percent between the ABPNI of all corporations (determined by the average of the 3 highest years of the base period) and their earnings rate in the pre-Korean quarter.

To maintain our position as an independent metals fabricator, it is imperative for us to match the moves of larger competitors into aluminum. To operate in the aluminum industry, tremendous sums are needed. In aluminum, we will be competing not only with the large integrated companies traditionally in that field, but also with the powerful integrated brass companies who have already entered the aluminum field.

Our progress into alumnium has been retarded under the excess profits taxes. These taxes siphoned off cash badly needed for expansion. They distorted and reduced our earnings record for 4 years and thus denied us reasonable acsess to vital equity capital.

Nor was our general need for new facilities met to any degree by certificates of necessity—generally denied our industry because of copper shortages.

A limited rights offering to our shareholders last November and December raised some additional funds, at a price hardly more than our 1953 pretax earnings and this was fortunately largely taken up by existing shareholders. This was, however, only a start on our aluminum requirements.

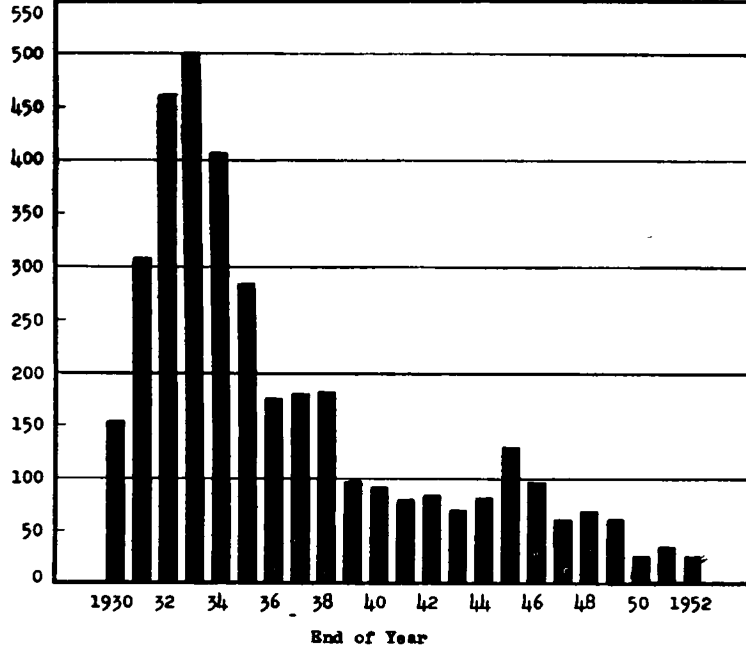
The skills, facilities, and resources of independent metal fabricators in this atomic-air age are becoming of increasingly vital importance to our country and the free world. The measure of our advances in metals may well be the measure of our strength. The maintenance and continued growth of vigorous independent metal fabricators are thus vital to the national interest.

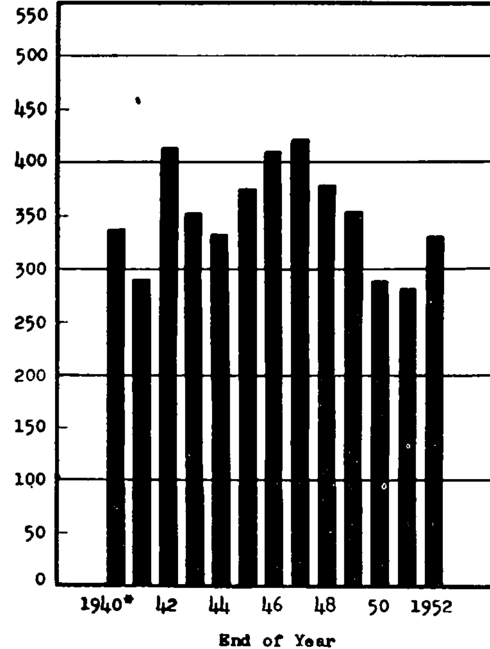
Many members of this committee have taken a sympathetic interest in our struggle for relief ever since 1950.

Our situation cries aloud for correction.

BRIDGEPORT BRASS COMPANY

YEAR-END STOCKS OF REFINED COPPER IN THE UNITED STATES





* Data for prior years are not available.

Source: Derived from United States Department of the Interior, Bureau of Mines.

EXHIBIT 2

Bridgeport Brass Co., growth since 1946

[In thousands]

	Net sales	Value of adjusted facilities at the beginning of the year	Excess profits net income (per Federal income tax returns)[1]
1946	$57,236	$7,213	$5,804
1947	60,347	9,501	3,944
1948	74,876	11,400	4,298
1949	54,746	14,723	(3,639)
1950	91,864	14,186	9,534
1951	101,711	14,079	10,843
1952	127,517	14,035	12,576
1953	142,649	15,386	19,114

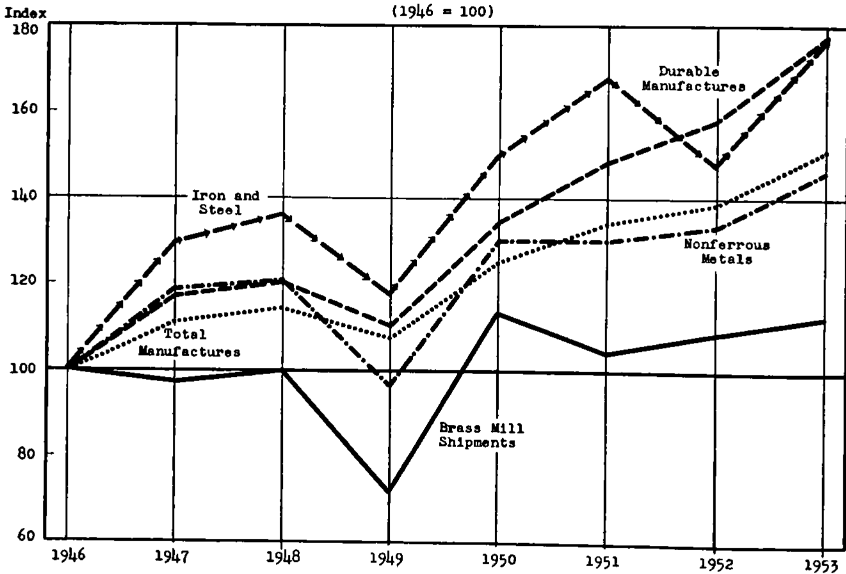
[1] These figures are Federal income tax return figures, adjusted to date, and will vary somewhat from published figures.

BRIDGEPORT BRASS COMPANY

INDICES OF PHYSICAL PRODUCTION OF NONFERROUS METALS, IRON AND STEEL, DURABLE MANUFACTURES, AND TOTAL MANUFACTURES, AND INDEX OF SHIPMENTS OF BRASS MILL PRODUCTS

1946 - 1953, INCLUSIVE

(1946 = 100)

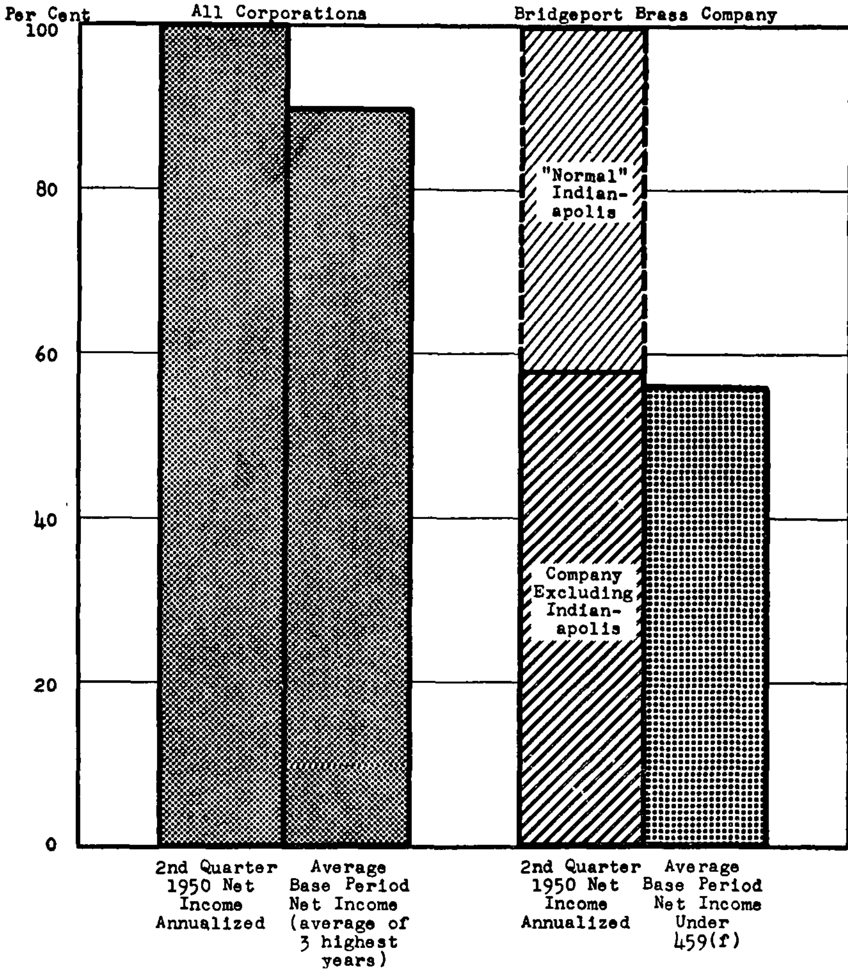


Source: Derived from:
Board of Governors of the Federal Reserve System
American Bureau of Metals.

BRIDGEPORT BRASS COMPANY

RELATION OF AVERAGE BASE PERIOD NET INCOME OF ALL CORPORATIONS AND OF THE BRIDGEPORT BRASS COMPANY TO THEIR RESPECTIVE SECOND CUARTER 1950 NET INCOMES ANNUALIZED

(Second Quarter 1950 Annualized = 100)

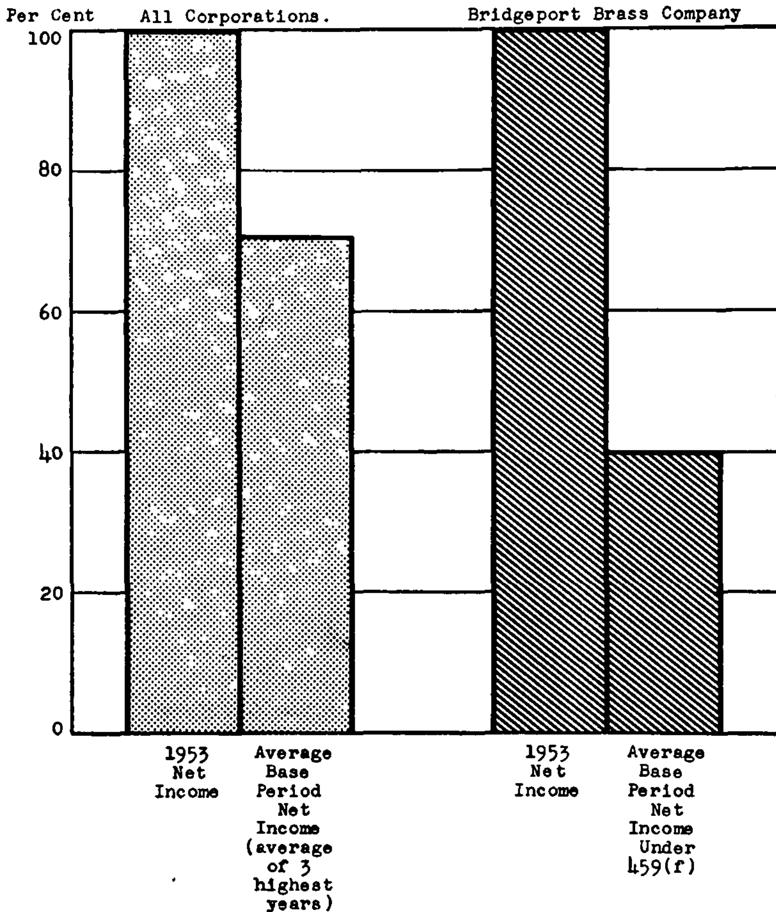


Source: Derived from:
Company Data.
United States Department of Commerce, Office of Business Economics.

BRIDGEPORT BRASS COMPANY

RELATION OF AVERAGE BASE PERIOD NET INCOME OF ALL CORPORATIONS AND OF THE BRIDGEPORT BRASS COMPANY UNDER SECTION 459(f) TO THEIR RESPECTIVE 1953 NET INCOMES

(1953 Net Income = 100)

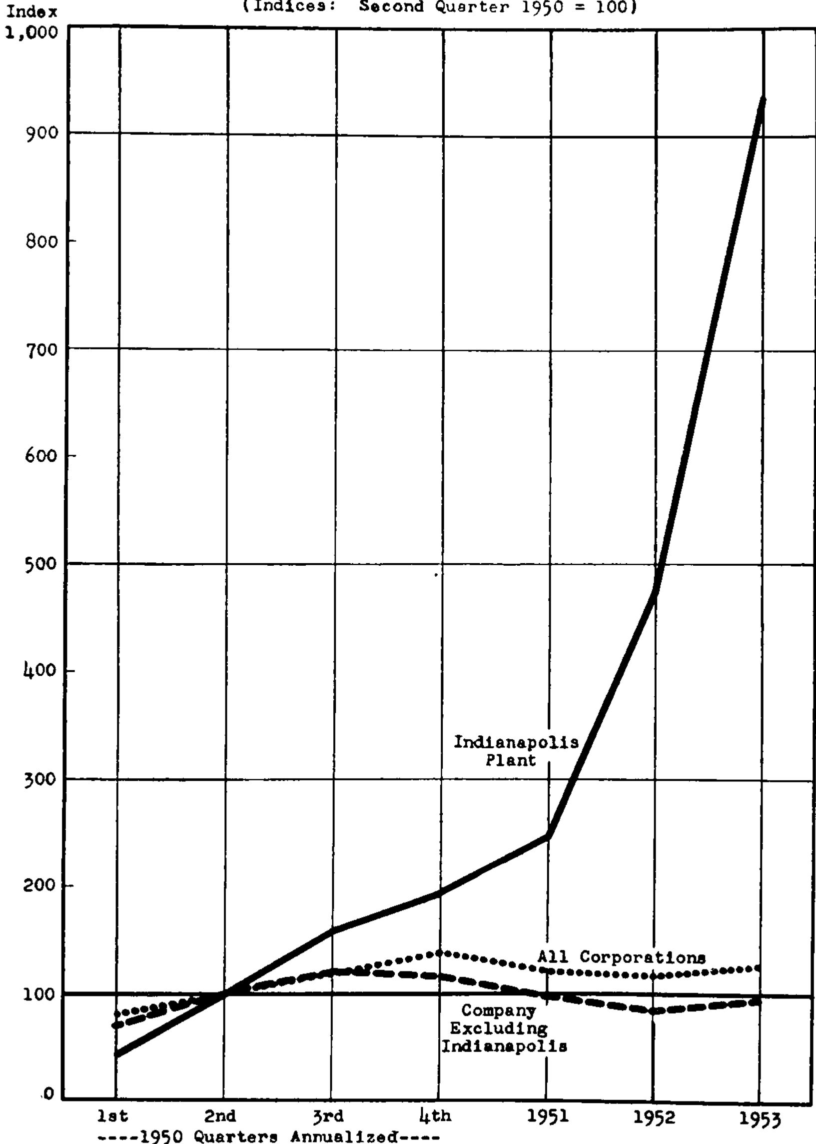


Source: Derived from:
Company Data.
United States Department of Commerce, Office of Business Economics.

BRIDGEPORT BRASS COMPANY

NET PROFIT TRENDS OF THE INDIANAPOLIS PLANT, THE COMPANY EXCLUDING INDIANAPOLIS, AND ALL CORPORATIONS, QUARTERLY (AT ANNUAL RATES) FOR 1950, AND ANNUALLY FOR 1951, 1952 AND 1953

(Indices: Second Quarter 1950 = 100)

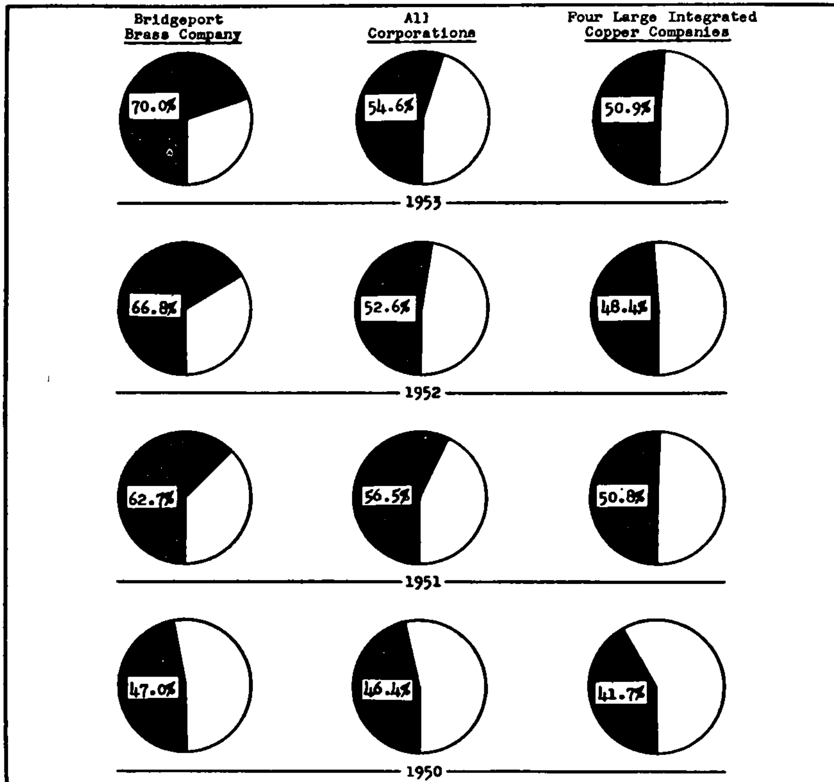


Source: Derived from:
Company Data.
United States Department of Commerce,
Office of Business Economics.

BRIDGEPORT BRASS COMPANY

EFFECTIVE TAX RATES (COMBINED INCOME AND EXCESS PROFITS TAXES AS PERCENTAGES OF NET INCOME) FOR THE BRIDGEPORT BRASS COMPANY, ALL CORPORATIONS, AND FOUR LARGE INTEGRATED COPPER COMPANIES

1950 - 1953, INCLUSIVE



Source: Derived from:
Company Data; Standard & Poor's Corporation.
United States Department of Commerce,
Office of Business Economics.

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

STATEMENT OF KENNETH W. FRASER, ASSOCIATION OF COTTON TEXTILE MERCHANTS

Mr. FRASER. Mr. Chairman and members of the committee, I have a prepared statement. May I read it to you?

The CHAIRMAN. Yes.

Mr. FRASER. My name is Kenneth W. Fraser. I am financial vice president of J. P. Stevens & Co., Inc., a manufacturer of textiles located in New York City. This statement is made on behalf of the Association of Cotton Textile Merchants of New York, whose headquarters are at 40 Worth Street, New York City. Our association is made up of sales organizations who are charged with the marketing of approximately 85 percent of the cotton broad woven goods produced in the United States, together with a substantial quantity of man-made fiber fabrics.

The opinions expressed herein have been checked with, and carry the endorsement of the American Cotton Manufacturers Institute, Inc., whose membership comprises the aforementioned manufacturers of 85 percent of the cotton broad woven goods produced in this country, and whose headquarters are located in Charlotte, N. C.

Under the provisions of section 6154 of H. R. 8300, over 35,000 corporations who pay about 90 percent of the Nation's corporate income tax would be required to pay 110 percent of the amounts actually due to the Government during each of the 5 years 1955 to 1959. In 1959 and later years, calendar-year corporations would be required to pay 25 percent of the current year's estimated tax liability in September, and another 25 percent in December. The unpaid balances would be paid in March and June of the succeeding year. Regarding the estimated payments, 6 percent interest would be charged for underestimates, if they are below 70 percent liability as finally determined after the close of the year.

We submit that the further extension of the "pay as you go" idea to corporation income-tax payments could seriously impair the credit structure of the entire Nation, by

1. Requiring corporations to increase their required bank loans to include estimated advance tax payments, in addition to the other reasonable needs of their operations;
2. Stifling the turnover of capital, by immobilizing cash in advance tax payments;
3. Retarding normal business operations by requiring corporations to use cash for tax payments in many instances before cash has been realized on consummated transactions.

Members of our industry have pointed out another serious pitfall. Take the case of the li-fo taxpayer who can certainly not estimate what his income will be until he knows what his inventory is at the close of the year. Corporations using the elective li-fo method for costing inventories cannot determine taxable income at intermediate periods during the year. Such corporations would find it factually impossible to make certain that payments prior to the balance sheet date at the end of the fiscal period were correct, within the limitations prescribed by H. R. 8300.

We sincerely believe that the House Ways and Means Committee, in undertaking the tremendous task of rewriting the entire tax law, may have overlooked the detrimental economic effects of 6154 of H. R. 8300.

To many corporations whose business is highly seasonal in character, the 6 percent penalty for underestimate would pose a nightmare of speculation. If substantial current payments were made under this proposal to avoid the penalty, and the season developed a loss rather than a profit, substantial working capital might be tied up at a time when such corporations need it most urgently.

Corporations in cyclical industries would be subjected to the same unfair "guessing game," if the first 6 months of the year were profitable but, after substantial payments were made, losses were incurred before the close of the taxable year.

If enacted into law, this proposal would also seriously impair the financial ability of corporations to proceed with plans for expansion and/or the development by research and advertising of the new prod-

ucts which are so vitally important to the continued growth and strength of the American economy.

The original Mills plan for accelerating tax payments did not require that such payments be made before corporate profits had been actually determined. It does provide the Government with additional revenues in earlier fiscal periods, that is, prior to June 30. However, the wholesale financial embarrassment of American corporations under the present proposal is estimated to provide only about $150 million of such pre-June 30 additional revenue. Is this inconsequential gain worth the risk that section 6154, by itself, could accelerate a recession of minor proportions into a serious depression?

It may be assumed by the individual taxpayer that if estimated Federal tax payments by the individual are good and fair for him, such estimated tax payments are good and fair for the corporation. In response, we draw your attention to the fact that in effectuating the Ruml "pay as you go" plan, three-fourths of the lower of the individual's tax due in 1942 or 1943 was forgiven. No such forgiveness is contemplated in connection with the proposed corporate plan.

Furthermore, estimates of personal income are based upon reasonable income expectations during the year, but with great latitude may be adjusted periodically as circumstances change and without regard to such important factors as inventories which are so vital in determining corporate profits.

The proposed legislation with respect to corporate anticipated payments does not recognize the seasonal and cyclical aspects of corporate income, and presents additional profound problems in corporate fiscal management.

Standard & Poor's Corp., which is not generally given to editorializing, in its publication, The Outlook, dated March 15, 1954, volume 26, No. 11, page 900, offers the following conclusion concerning the extension of the Mills plan to corporate tax payments.

> On the whole, this plan sticks out like a sore thumb in an overall tax program that is otherwise aimed at encouraging business as a means of generating prosperity.

For the foregoing reasons, we urge that this committee delete section 6154 and related sections of H. R. 8300 from the bill.

The CHAIRMAN. We are glad to have your presentation. There have been a number of complaints on this provision. I don't know what the outcome will be, but it will be very carefully considered.

Mr. FRASER. Mr. Chairman, thank you kindly, and your committee, for offering to listen to this viewpoint and taking it into further consideration.

The CHAIRMAN. Thank you.

Now, Mr. Uhlmann. Mr. Uhlmann, sit down and be comfortable and identify yourself to the reporter.

STATEMENT OF RICHARD F. UHLMANN, CHICAGO BOARD OF TRADE

Mr. UHLMANN. Mr. Chairman, members of the Committee on Finance, my name is Richard F. Uhlmann. I am president of the Uhlmann Grain Co. and a former president of the Chicago Board of Trade. I appear before your committee on behalf of the Board of Trade to urge two changes in subchapter P of chapter 1 of H. R. 8300 to stimulate the market in the agricultural commodities which are traded on our exchange and on other similar exchanges.

To appreciate the need for these changes, it is necessary to understand the nature of the Board of Trade and similar commodity exchanges and their importance to agriculture in our economy. The commodity markets deserve and need a better appreciation.

The one thing that I would like to impress strongly upon this committee is that the Board of Trade is merely a public market place, providing the facilities for the farmers who grow grain and other products to meet buyers. Bartering between these people establishes the price of grain at any given moment. The Board of Trade itself has nothing whatsoever to do with the price. That is determined by the buyers and sellers, and is based upon the supply and demand. All the Board of Trade does is to publicize the prices established by these sales, through a widespread telegraphic system, and the radio and news agencies of the Nation.

In addition to maintaining a commercial exchange, we acquire and disseminate valuable economic and commercial information. We strive to promote uniformity in the customs and usages of merchants. We also facilitate the speedy adjustment of business disputes.

The commercial exchanges throughout the country are subject to Federal regulation, and we operate under the Commodity Exchange Authority.

Through the commodity exchanges, uniformity of prices is now possible all over the country. A year-around market is provided farmers instead of just the period following harvest. Violent price fluctuations are minimized and better grain values are determined.

It must be remembered that the farmer harvests his grain only once during the year. On the other hand, the public needs to eat that grain and products made from grain throughout the entire year. Consequently, some system had to be provided to buy the grain when it was offered, but to distribute it evenly on the market throughout the entire year.

This is possible only through the operation of the futures markets, where crops are bought and sold before they are harvested. The traders in commodity futures smooth out the buying and selling of grain with an efficiency and economy unrivalled in our economic system—or anywhere in the world.

The futures traders who deal on the commodity exchanges also make it possible for producers, manufacturers, and other dealers in agricultural commodities to insure themselves against unfavorable price changes. It is this insurance feature of the commodity exchanges which I would like to emphasize to this committee today, and on which we badly need your help.

Every local elevator operator who purchases grain from the farmer, every terminal elevator operator who buys from the local operator, every flour miller or cereal producer or feed processor who buys from the elevators, must avoid the risk of the frequent changes in market prices of agricultural products.

My company operates grain elevators. We could not pay the farmer $2 per bushel for wheat unless we could insure against the possibility that, before we resell, the price may have dropped to $1.85 per bushel. Similarly, a flour mill cannot contract to sell flour in the future at a price calculated on the basis of a current wheat price of $1.85 per bushel, without insuring against the possibility that wheat

may have climbed to $2 per bushel before it buys the grain to fill that order.

At all stages, from farmer to consumer, the risk of an adverse price change is shifted by hedging in the futures market. A buyer of physical grain hedges by agreeing to sell the same quantity at the same price at a future date; if the price decreases, his loss on the grain he holds is offset by a profit on the contract he held to sell other grain at the higher price.

An example of a hedge is printed in the margin of my statement, and it is a little complicated, Mr. Chairman. I will not enter into the discussion here.

In order to shift the risk of a price change, the hedger must find someone who is willing to assume the risk—and he must find that person promptly. This is where the commodity exchanges become indispensable. Through the exchanges the hedger can sell to traders in commodity futures who are willing to take the risk. These traders in futures will either buy or sell commodities for future delivery at a specified price in the hope and expectation that any price change will be favorable to them.

Without the futures traders, hedging would be nonexistent. Without the commodity exchanges to bring the hedger and the futures trader together, hedging on a large scale would be utterly impossible. Moreover—and this is the critical point which I would like the committee to understand—the price of agricultural produce paid the farmer would decline and the cost of the end use product to the consumer would increase. This relationship of the trader to the farmer and the consumer was stated to this commitee by the Administrator of the Commodity Exchange Authority in a letter advocating the repeal of stamp taxes on futures trading. The Administrator said that, without the traders—

> hedgers desiring to sell a future as a protection against loss would be compelled to sell at a lower price, and hedgers desiring to buy a future as a protection against the sale of flour would be compelled to pay a higher price than justified. In the former case, the result would be a lower price to producers and in the latter case a higher price to consumers.

Now, mind you, this came from Mr. Mehl, who is the Administrator of the CEA.

And he also summed up the importance of an active and liquid futures market before this committee. He said that the Commodity Exchange Authority—

> wishes to see a futures market that will serve most adequately the needs of hedgers and handlers of the actual commodity. To be of value to hedgers, a futures market must be liquid. It must be a readily available market. It must be a market which will absorb instantly fairly large buying and selling orders without price disturbance. Such a market does enable distributors of the actual commodities to operate on a smaller margin of profit because it enables them to shift the burden of price risk which would otherwise be a part of their cost of handling.

From this it is clear that not only we who deal in commodities but the farmers and consumers of the Nation will benefit from stimulation of commodity trading.

A stimulus is needed. The volume of futures trading has declined over the last 20 years, although our national crops have increased in size. On all grains the total volume of trading in 1952 was at the 1932 level, although national grain production in 1952 exceeded 1932 pro-

duction by over a billion bushels. In wheat, the volume of futures trading in each of the last 9 years was lower than at any time during the depression although the wheat crop for each of those 9 years was larger than any previous crop in our history. Graphs reflecting these illustrations appear as a part of the board of trade's statement in the transcript of hearings on this bill before the Committee on Ways and Means.

Senator BUTLER. Is it a fair statement to say that possibly the drop in futures trading over these years was due perhaps to the Government loan plan?

Mr. UHLMANN. To some extent; yes, sir. I think all artificial factors would tend to restrict trading, but, on the other hand, the crops were so large since 1944. We have had 1 billion bushel wheat crops successively each year, with 1 exception, and the trading has gone down. As our chart will show, as the tax went up, trading went down. Now, there were, naturally, other contributing factors.

The CHAIRMAN. How has that dislocation been handled?

Mr. UHLMANN. It has been handled partially by the fact that we had the Government loans and that a large part of the grain was impounded. But, by the same token, it put more grain into the Government warehouses and the Government's supply. The result has been that we have had these accumulations, and with the additional space that the Government is building they will have at the end of next month 735 million bushels of storage space to keep these grains that have been accumulated.

Senator BUTLER. That is almost a year's crop.

Mr. UHLMANN. That is a little over that, sir; 700 million bushels is what we consume, including feed, seed, and bread usage.

The CHAIRMAN. Now, what is there about this bill that you want to change?

Mr. UHLMANN. We feel, sir, that we would like to have the holding period cut from 6 months to 2 months in order to bring more traders and speculators into the market to absorb the hedges which a firm like my own has to place. A 6-month holding period brings into play too many factors. There is not a month in the year when wheat is not harvested in some country in the world. When we finish our harvests in this country in July and August, Canada starts her harvest. And in November, December, and January the harvest starts in Argentina and Australia.

The conditions change so rapidly that when a person is compelled to hold a contract for a period of 6 months it becomes a great gamble, and we can't interest people. We are asking that we be given consideration due to the fact that our comodities are perishable and due to the fact that wheat is raised everywhere in the world. If we should be given a 2-month period instead of a 6-month period we could attract more people into the market and maintain a liquid market.

Senator BUTLER. The profits traders expect to make would be taxed on a capital-gains basis.

Mr. UHLMANN. That is correct. And it discourages a great many people from coming into the market, when they feel they would have to be in there for a period of 6 months, when so many factors are changing, and a new supply in other parts of the world becomes evident.

Senator BUTLER. It is true there are other trading markets besides the Chicago Board of Trade.

Mr. UHLMANN. That is correct.

Senator BUTLER. But most of them perhaps do some hedging through the Chicago Board of Trade.

Mr. UHLMANN. They do. As a matter of fact, 85 percent of the futures trade is in Chicago. The other markets, such as Kansas City and Minneapolis, are also very important. They are largely cash markets. For futures trading a good deal of the operations in the secondary markets or in the interior markets are offset in Chicago.

Senator WILLIAMS. The bulk of the milling industry and the feed industry use the Chicago Board of Trade as hedging operations on their future supply and sales purchases; is that not true?

Mr. UHLMANN. That is correct.

Senator WILLIAMS. If the committee desires to give favorable consideration and accepts your recommendations and reduces the time limit, would it not be possible for the bulk of the millers to transfer all of their earnings on the sale of flour and feed to the capital-gains provision by virtue of the example that you put here?

Mr. UHLMANN. I don't believe so, sir, and I will tell you why. Now, I come here as a grain man, and not a miller, but I think that the miller has very much the same situation as we do. Any relaxation in this tax law wouldn't benefit my firm or General Mills or Pillsbury or International one iota. And we are not asking for any personal favors. All that we are asking is that when we place a hedge, either long or short, that we have enough traders on the other side of the market who can be induced to take and assume that risk. But, as far as the industry is concerned, it wouldn't affect them one iota.

Senator WILLIAMS. I don't quite follow you, because using your example there on page 4, the miller that sells or buys his future wheat on the Chicago Board of Trade as a hedging operation, and then a couple of months later he delivers the flour, in the meantime the flour market has declined, and then he buys the wheat. As you will note—and I know that it is true—the profit is transferred from a profit on the operation of the flour to a profit on the transfer——

Mr. UHLMANN. That is correct.

Senator WILLIAMS. He has the advantage of transferring that profit from flour over to capital gains.

Mr. UHLMANN. It wouldn't work out any different than where you have the grocer at the corner grocery store. He might hold his groceries for 6 or 7 months, and he couldn't take a capital-gains tax under the law. We are not asking for that. The way his tax is computed, he pays on the actual profit as offset by the loss.

Senator WILLIAMS. You mean, just using this example that you have, the man that purchases this wheat, even though it was a hedging operation, rather than a speculative operation—I don't see how you could distinguish it.

Senator BUTLER. I think possibly there is this difference, that the hedging operation is to protect the price of the raw material, not to protect his operating profit or projected operating profit in the manufacture of that flour.

Senator WILLIAMS. I understand that, and I recognize the difference you are pointing out, but the question I raise is from the standpoint of the application of the tax law, the fact that the miller might

have $10,000 profit in his hedging operation. Why would that not be subject to the same capital gains provision? It is under present law.

Mr. UHLMANN. I am not really a tax expert. I would like to explain it if I could, but I know it doesn't work out that way. And what we were asking in this statement is merely for consideration on the part of the speculator or the trader. It has never worked out to be a capital gain for hedgers, and I am sure your staff members here will explain that to you. We in our business have held wheat sometimes for a year, but we still pay on the net profit or loss, irrespective of the holding period.

Senator WILLIAMS. I understand that. But that is why your holdings are represented in elevators. If your holdings represent an inventory that is purchased through the Chicago Board of Trade, there would be a difference. We will check that later.

Mr. UHLMANN. Yes, you better check it. As I say, I am not a tax expert, but to my knowledge it has never worked out that way for either a miller or a grain operator.

Senator BUTLER. Off the record.

(Discussion off the record.)

Mr. UHLMANN. May I continue?

While a number of factors may have contributed to this decline of interest in commodity trading, the tax treatment accorded to the trader has been a major cause. The primary difficulty is that the trader in futures is required to hold his risk for a full 6 months or pay tax at ordinary income rates on any profits he may make. The commodity trader can seldom meet the 6 months' requirement, and, therefore, more and more persons are leaving the commodity markets and looking to the securities market, where long-term capital gains are feasible.

The commodity trader cannot meet the 6 months' requirement for two reasons: First, the life of a futures contract is quite often less than 6 months at the time of trading. For example, if one trades after June in a commodity which must, under existing rules, be delivered in December, the contract must expire in less than 6 months. Second, the domestic price of commodities depends directly upon the size of crops being harvested monthly over the globe. To illustrate the risks to a trader in wheat futures due only to possible variances in the world's grain supply, I have appended a schedule showing the harvesting of the world's wheat crops during each month of the year.

The CHAIRMAN. What are you suggesting as a correction?

Mr. UHLMANN. The correct period?

The CHAIRMAN. No, a correction of the situation you are talking about.

Mr. UHLMANN. Shortening the holding period. We would like to bring it down to 2 months. We feel 6 months is entirely too long for a perishable commodity, and we don't believe that we can get people to come in and support our market, the same as you could in—excuse me, Senator.

Senator BUTLER. It has been a good many years since I have been in the grain business, and I haven't had one single trade in the market since I became a candidate for the Senate in 1939, so I may be way out of date in my ideas, but I can't understand the logic for your request to change it from 6 months to a shorter period. I was wonder-

ing if the committee might be inclined to give it consideration for 3 months, if it would solve the problem to any extent?

Mr. UHLMANN. It would help. I don't think it would be quite as beneficial. Three months is naturally a big reduction from 6 months. It is like the man who is sentenced to a year in jail; he would rather take 6 months if he could get it. And we would take 3 months, but we are pleading for 2, because we think that not only would the Treasury Department earn more and collect more but we think we could stimulate trade and bring more people into the market.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Senator BUTLER. I think it is a plain fact that we must all recognize that few options have a life of 6 months.

Mr. UHLMANN. There are some. We have had to put some in for a long period just to try to bring people into a market of that kind.

If you will see the last sheet on this report, we have shown here how a commodity like wheat is raised practically every place in the world, in every clime—in northern countries like Siberia, with its unremitting cold, wheat is grown. And when you consider that in January you have a harvest in Chile, New Zealand, and Australia, and Argentina; in February you have the harvest in upper Egypt and India; in March you have it in Egypt, India, and Pakistan; in April you have it in Cyprus, Egypt, Persia, Mexico, Middle America, Syria, and so on, it makes it impossible. A man may figure for 3 months ahead, but when he has to go 6 months ahead, everything changes so radically that it keeps people from entering into long commitments.

That is the reason we say that we should have some relief if it is desirable—and we think it is—that the liquidity of markets be maintained.

Now, I would like to talk about one more thing and this won't take but a moment. That is the treatment of short sales, because we believe that a short sale is subjected and exposed to the same risk as a long.

As if all the forces already mentioned proscribing the opportunity for long-term gain were not enough, the Treasury has adopted a policy which flatly precludes any long-term gain on short sales of commodity futures.

A short sale in the futures markets is an agreement to deliver a specified commodity in a future month at a stated price. The seller usually does not possess the commodity to be delivered, and he satisfies his sale contract by purchasing an offsetting contract on the futures market instead of making delivery under his first agreement.

Although section 117 (g) (1) of the Internal Revenue Code now specifies that gains and losses from short sales of property may constitute capital gains and losses, such capital gains and losses are treated as short term, regardless of the time interval between the short sale and the offsetting purchase. This result has been defended by the Treasury Department with the argument that the short trader owns no property which he can hold for a 6-month period, or any other period. This position is thoroughly unrealistic. A contract is legally a property and contracts for short sales are one of our old and established methods of commodity trading. They present a real method of making capital gains and the ancient customs of the market place should have greater recognition.

In the commodity market, the short trader is absolutely indispensable. The trader who sells short performs exactly the same function in the commodity futures market as the long trader. Both the buying and selling of futures is essential for an active and liquid market. Both are necessary to satisfy the needs of the hedger—who either sells or buys, depending upon whether he is protecting an inventory or an advance sale of finished products. There is no difference between the short and longer trader which requires different tax treatment.

In order to treat alike the trader who trades long or short in the futures market, section 1233 of H. R. 8300 should be amended to provide that in the case of a short sale, the holding period shall begin with the execution of the sales contract, except in those special cases at which the 1950 amendment was directed.

I thank you very much.

The CHAIRMAN. We are glad to have you.

(The prepared statement of Mr. Uhlmann follows:)

STATEMENT ON BEHALF OF THE BOARD OF TRADE OF THE CITY OF CHICAGO

My name is Richard F. Uhlmann. I am the president of the Uhlmann Grain Co., and a former president of the Chicago Board of Trade. I appear before your committee on behalf of the board of trade to urge two changes in subchapter P of chapter 1 of H. R. 8300 to stimulate the market in the agricultural commodities which are traded on our exchange and on other similar exchanges.

To appreciate the need for these changes, it is necessary to understand the nature of the board of trade and similar commodity exchanges and their importance to agriculture in our economy. The commodity markets deserve and need a better appreciation.

The one thing that I would like to impress strongly upon this committee is that the board of trade is merely a public market place providing facilities for the farmers who grow grain and other products to meet buyers. Bartering between these people establishes the price of grain at any given moment. The board of trade itself has nothing whatsoever to do with the price. That is determined by the buyers and sellers, and is based upon the supply and demand. All the board of trade does is to publicize the prices established by these sales through a widespread telegraphic system, and the radio and news agencies of the Nation. In addition to maintaining a commercial exchange we acquire and disseminate valuable economic and commercial information. We strive to promote uniformity in the customs and usages of merchants. We also facilitate the speedy adjustment of business disputes.

The commercial exchanges throughout the country are subject to Federal regulation, and we operate under the Commodity Exchange Authority.

Through the commodity exchanges, uniformity of prices is now possible all over the country. A year-around market is provided farmers instead of just the period following harvest. Violent price fluctuations are minimized and better grain values are determined.

It must be remembered that the farmer harvests his grain only once during the year. On the other hand, the public needs to eat that grain and products made from grain throughout the entire year. Consequently, some system had to be provided to buy the grain when it was offered, but to distribute it evenly on the market throughout the entire year.

This is possible only through the operation of the futures markets, where crops are bought and sold before they are harvested. The traders in commodity futures smooth out the buying and selling of grain with an efficiency and economy unrivaled in our economic system or anywhere in the world.

The futures traders who deal on the commodity exchanges also make it possible for producers, manufacturers, and other dealers in agricultural commodities to insure themselves against unfavorable price changes. It is this insurance feature of the commodity exchanges which I would like to emphasize to this committee today, and on which we badly need your help.

Every local elevator operator who purchases grain from the farmer, every terminal elevator operator who buys from the local operator, every flour miller or

cereal producer or food processor who buys from the elevators, must avoid the risk of the frequent changes in market prices of agricultural products. My company operates grain elevators. We could not pay the farmer $2 per bushel for wheat unless we could insure against the possibility that before we resell the price may have dropped to $1.85 per bushel. Similarly, a flour mill cannot contract to sell flour in the future at a price calculated on the basis of a current wheat price of $1.85 per bushel without insuring against the possibility that wheat may have climbed to $2 per bushel before it buys the grain to fill that order.

At all stages, from farmer to consumer, the risk of an adverse price change is shifted by hedging in the futures market. A buyer of physical grain hedges by agreeing to sell the same quantity at the same price at a future date; if the price decreases, his loss on the grain he holds is offset by a profit on the contract he held to sell other grain at the higher price.

An example of a hedge is printed in the margin.[1]

But in order to shift the risk of a price change, the hedger must find someone who is willing to assume the risk and he must find that person promptly. This is where the commodity exchanges become indispensable. Through the exchanges the hedger can sell to traders in commodity futures, who are willing to take the risk. These traders in futures will either buy or sell commodities for future delivery at a specified price, in the hope and expectation that any price change will be favorable to them.

Without the futures traders, hedging would be nonexistent. Without the commodity exchanges to bring the hedger and the futures trader together, hedging on a large scale would be utterly impossible. Moreover—and this is the critical point which I would like the committee to understand—the price of agricultural produce paid the farmer would decline and cost of the end use product to the consumer would increase. This relationship of the trader to the farmer and the consumer was stated to this committee by the Administrator of the Commodity Exchange Authority in a letter advocating the repeal of stamp taxes on futures trading (S. Rept. 1567, 75th Cong., 3d sess. 12 (1938)). The Administrator said that, without the traders, "hedgers desiring to sell a future as a protection against loss would be compelled to sell at a lower price and hedgers desiring to buy a future as a protection against the sale of flour would be compelled to pay a higher price than justified. In the former case the result would be a lower price to producers and in the latter case a higher price to consumers."

The Administrator also summed up the importance of an active and liquid futures market before this committee (hearing before Committee on Finance on H. R. 9682, 75th Cong., 3d sess., pt. 4, 117 (1938)). He said that the Commodity Exchange Authority "wishes to see a futures market that will serve most adequately the needs of hedgers and handlers of the actual commodity. To be of value to hedgers, a futures market must be liquid. It must be a readily available market. It must be a market which will absorb instantly fairly large buying and selling orders without price disturbance. Such a market does enable distributors of the actual commodities to operate on a smaller margin of profit, because it enables them to shift the burden of price risk which would otherwise be a part of their cost of handling." From this it is clear that not only we who deal in commodities, but the farmers and consumers of the Nation will benefit from stimulation of commodity trading.

A stimulus is needed. The volume of futures trading has declined over the last 20 years, although our national crops have increased in size. On all grains the total volume of trading in 1952 was at the 1932 level, although national grain production in 1952 exceeded 1932 production by over a billion bushels. In wheat, the volume of futures trading in each of the last 9 years was lower

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[1] An example of a typical hedging transaction involves purchases and sales as follows:

ON SEPTEMBER 1

In the cash market, a miller buys 5,000 bushels of wheat at $2 per bushel.	He sells 5,000 bushels of December wheat futures at $2 per bushel

ON OCTOBER 20

He sells flour based on a wheat content of 5,000 bushels at $1.85 per bushel of wheat.	He buys 5,000 bushels of December wheat futures at $1.85 per bushel.

SUMMARY

He lost $0.15 per bushel on the sale of the physical wheat.	He made a profit of $0.15 per bushel on the wheat futures.

than at any time during the depression, although the wheat crop for each of those 9 years was larger than any previous crop in our history. Graphs reflecting these illustrations appear as a part of the board of trade's statement in the transcript of hearings on this bill before the Committee on Ways and Means (pt. 2, 1093, 1102–1105).

While a number of factors may have contributed to this decline of interest in commodity trading, the tax treatment accorded to the trader has been a major cause. The primary difficulty is that the trader in futures is required to hold his risk for a full 6 months or pay tax at ordinary income rates on any profits he may make. The commodity trader can seldom meet the 6-month requirement, and, therefore, more and more persons are leaving the commodity markets and looking to the securities market, where long-term capital gains are feasible.

The commodity trader cannot meet the 6-month requirement for 2 reasons: First, the life of a futures contract is quite often less than 6 months at the time of trading. For example, if one trades after June in a commodity which must under existing rules, be delivered in December, the contract must expire in less than 6 months. Second, the domestic price of commodities depends directly upon the size of crops being harvested monthly over the globe. To illustrate the risks to a trader in wheat futures due only to possible variances in the world's grain supply, I have appended a schedule showing the harvesting of the world's wheat crops during each month of the year. The possible variations due to weather, disease, and insects in all the areas where wheat will be harvested over a 6-month period, in addition to normal changes of general economic activity, are too much to foresee for a 6-month period. As a result, people are unwilling to hold commodity futures for 6 months.

It is not only fair but necessary to reduce the requirement of a 6-month holding period to 2 months for commodity trading. Two months more nearly reflects the risk which the commodity trader can and will assume. Such a provision would bring back to the commodity markets a volume of trading that will give the country the liquid and stable market which hedgers badly need.

TREATMENT OF SHORT SALES

As if all the forces already mentioned proscribing the opportunity for long-term gain were not enough, the Treasury has adopted a policy which flatly precludes any long-term gain on short sales of commodity futures.

A short sale in the futures market is an agreement to deliver a specified commodity in a future month at a stated price; the seller usually does not possess the commodity to be delivered, and he satisfies his sale contract by purchasing an offsetting contract on the futures market instead of making delivery under his first agreement.

Although section 117 (g) (1) of the Internal Revenue Code now specifies that gains and losses from short sales of property may constitute capital gains and losses, such capital gains and losses are treated as short term, regardless of the time interval between the short sale and the offsetting purchase. This result has been defended by the Treasury Department with the argument that the short trader owns no property which he can hold for a 6-month period—or any other period. This position is thoroughly unrealistic.[2] A contract is legally a property and contracts for short sales are one of our old and established methods of commodity trading. They present a real method of making capital gains and the ancient customs of the market place should have greater recognition.

In the commodity market, the short trader is absolutely indispensable. The trader who sells short performs exactly the same function in the commodity futures market as the long trader. Both the buying and selling of futures is essential for an active and liquid market. Both are necessary to satisfy the needs of the hedger—who either sells or buys, depending upon whether he is protecting an inventory or an advance sale of finished products. There is no difference between the short and long trader which requires different tax treatment.

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[2] The Treasury position was apparently written into existing sec. 117 (1) of the Internal Revenue Code, although not for the reasons underlying the Treasury's previous policy. Sec. 117 (1) was enacted in 1950 for the express purpose of preventing the conversion of losses from long term to short term and of gains from short term to long term through the expedient of maintaining offsetting long and short positions on 2 markets and closing out the 2 contracts at such times as to acquire the most beneficial treatment. While no one could quarrel with the purpose of this statute, the purpose could have been achieved without penalizing all short traders. We find no indication in the legislative annals that Congress intended to do so. The new bill, H. R. 8300, makes no substantial change in this situation.

In order to treat alike the trader who trades long or short in the futures market, section 1233 of H. R. 8300 should be amended to provide that in the case of a short sale the holding period shall begin with the execution of the sales contract. except in those special cases at which the 1950 amendment was directed.

MAIN AREAS OF WHEAT PRODUCTION

- January:
  - Argentina
  - Chile
  - New Zealand
  - Australia
- February:
  - Upper Egypt
  - India
- March:
  - Egypt
  - India
  - Pakistan
- April:
  - Cyprus
  - Egypt
  - Persia
  - Mexico
  - Middle America
  - Syria
- May:
  - Algeria
  - Morocco
  - Syria
  - Persia
  - China
  - Japan
  - Florida (U. S. A.)
  - Texas (U. S. A.)
- June:
  - South Europe
  - South Russia
  - U. S. A.—Southern States
- July:
  - Middle, west, and south Europe
  - Poland, Russia
  - Turkey
  - U. S. A. (Middle West)
- August:
  - Middle, west, and south Europe
  - Poland
  - Russia
  - Turkey
  - U. S. A. (Middle West)
- September:
  - North Europe
  - Northern Russia
  - U. S. A. (Northern States)
  - Canada
- October:
  - Canada
  - Northern Russia
- November:
  - Northern Australia
  - Manchuria
  - Peru
  - South Africa
- December:
  - New Zealand
  - Australia
  - Argentina
  - Chile
  - South Africa

The CHAIRMAN. Mr. Hazard. Sit down and make yourself comfortable and identify yourself to the reporter.

STATEMENT OF LELAND HAZARD, VICE PRESIDENT AND GENERAL COUNSEL, PITTSBURGH PLATE GLASS CO.

Mr. HAZARD. Mr. Chairman and gentlemen of the committee, my name is Leland Hazard. I am vice president and general counsel of the Pittsburgh Plate Glass Co., with headquarters in Pittsburgh, Pa., and we have sales branches in most of the States of the Union.

I address myself to an inequity and discrimination which exists in the determination of the base for applying the manufacturers' excise tax on automobile glass. I am going to propose a remedy which would not reduce the revenue from this source, if the tax were applied uniformly on the manufacturer's price, as I think Congress intended, but would simply translate the present tax of 8 percent of that price to a flat tax of 12.8 cents per square foot.

I would like to say, Mr. Chairman, that I am not proposing a fixed amount per square foot. This is a matter of calculation which the Bureau can easily determine. It is rather the translation from a percentage of sales price to an amount per square foot which I propose.

Now, this tax on automotive glass is imposed by section 4061 of the bill, and this section relates to automobile accessories.

When the manufacturer of automotive glass sells to the automobile manufacturer for original installation, there is no tax, because the automobile as an entirety is taxed. So that sale is an exempt transaction. We are dealing here only with automotive glass used for replacement——

The CHAIRMAN. Does this proposed bill change the tax in any way?

Mr. HAZARD. No; it does not. That is in our point. It carries over what has been in the present law. And we are here to ask for the correction of an inequity which exists in the present law and would be continued in the new bill.

Now, as I said, I speak for the Pittsburgh Plate Glass Co.

The CHAIRMAN. Just to be perfectly candid with you, I doubt very much whether we are going to get into the subject of changing excise tax rates in this.

Mr. HAZARD. I realize that, Mr. Chairman. What I would like to say to you is that we are not proposing any change in revenue; we are proposing only a change in the method of the calculation of the tax. We are not asking for an exemption or an alteration in the revenue; we are asking only for a correction in what at the present time amounts to an inequity against—and I will say frankly, sir—one taxpayer.

It comes about in this way: Pittsburgh Plate Glass Co. sells the major portion of its automotive glass through its own distribution outlets, and since this is so, the tax must be paid, under the present law and under the proposed revision, upon the wholesale price rather than upon the manufacturer's price.

Now, all of our competitors pay the tax at the lower level of the manufacturing price, the price at the factory, because no competitor of ours owns its distribution. And, in our case, the first sale occurs at the secondary rather than the primary level, and this is a serious competitive disadvantage.

I would like to give you a quick illustration: When one of our competitors sells to an independent distributor, the tax falls at the level of the sale at the factory. For example, an article sold by one of our competitors to an independent distributor for $10 would bear, at 8 percent, a tax of 80 cents. The distributor who has purchased the article at a cost of $10.80 can sell it without further concern for the excise tax. If this independent distributor sells it for $20 to a dealer, he has no further concern about the excise tax. He has paid the tax and has a cost of $0.80 added to the $10. But, in the case of the Pittsburgh Plate Glass Co., which sells mainly through its company's own distribution outlets—184 of them, as I will mention to the committee in a few minutes—the tax falls then at the higher level. Say $20 is the wholesaler's resale price. So the tax paid by Pittsburgh Plate Glass Co. is $1.60, or twice the amount that the competitor pays.

Now, this results in a lack of uniformity of the base, as between differing methods of distribution—and these methods are validly selected. One manufacturer selects one method, and another manufacturer another, for various reasons. But the imposition of the manufacturer's excise tax occurs, in our case, upon an amount which is in no proper sense a part of the manufacturer's price. And this we

think does violence to the congressional intent which was to impose the tax at the manufacturer's level.

We think this is clear from the wording of the statute which applies "to the manufacturer, producer, or importer." It is not a tax, according to the language of the statute, at any level except at the level of manufacture.

Now, we propose a very simple method of curing this inequity—by converting the tax to a rate per square foot, rather than as a percentage of the sales price. We have made a calculation. A tax of 12.8 cents per square foot would yield the same revenue as 8 percent of the sale value at the manufacturing level.

We made a careful study of 1953, a year of high-level production, a year that we regard as typical. But we are not asking for a particular amount per square foot. We are asking for a change from the percentage of sales prices, which creates this inequity, to an amount per square foot.

Now, we think that administratively this would be an advantage to the Government. For example, at the present time the tax paid by Pittsburgh Plate Glass Co. under the present law is computed at 184 separate sales establishments. Under this proposal, the tax would be computed at only two factories. So that we think that the problem of the Internal Revenue Service in the administration and auditing would be greatly simplified.

The proposal merely changes the computation of the manufacturers' excise tax on automotive replacement glass from a percentage of sales price to a rate per square foot and cures in our industry the inequity which has already been cured by the same method in the rubber-tire industry. The manufacturers of tires sell tires for replacement on automobiles. We sell the windshields, the side windows, the rear windows—the same sort of thing. And in the case of the rubber-tire industry the tax is so many cents per pound, designed to prevent in advance exactly the inequity which has occurred here—because, as the chairman well knows, and the Senator well knows, some of the rubber-tire companies have their own distribution outlets, just as we have our own. Others do not. So there would be an inequity in that industry if the tax were on a percentage basis.

So we think that this provision of law for the rubber-tire industry is a very important precedent for what we propose here.

We have submitted and attached to this statement, Mr. Chairman, a draft of a section which would accomplish this correction of an inequity, and I am very grateful for the opportunity to appear here.

The CHAIRMAN. We are very glad to have you. Your statement will be put in the record.

(The prepared statement of Mr. Hazard follows:)

STATEMENT BY LELAND HAZARD, VICE PRESIDENT AND GENERAL COUNSEL OF PITTSBURGH PLATE GLASS CO., CONCERNING SECTION 4061 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954

To Senate Finance Committee, Hon. Eugene D. Millikin, Chairman, Washington, D. C.:

Mr. Chairman and gentlemen of the committee, my name is Leland Hazard. I am vice president and general counsel of the Pittsburgh Plate Glass Co., of Pittsburgh, Pa.

I wish to address myself to the inequity and discrimination which exists in the determination of the base for applying the manufacturers' excise tax on automotive glass. The remedy which I propose would not reduce the revenue from

this source if the tax was applied uniformly on the manufacturers' price as Congress intended, but would simply translate the present tax of 8 percent of that price to a flat tax of 12.8 cents per square foot.

The tax on automotive glass is imposed by section 4061 of the bill (sec. 3403 (c) of the Internal Revenue Code). The section relates to automobile accessories (including automotive glass, but not tires and radios).

When the manufacturer of automotive glass sells to the automobile manufacturer for original installation, there is no tax because the automobile itself is taxed in its entirety. We are dealing, therefore, with automotive glass that is used for replacement. It is only this type of glass with which we are concerned.

Since PPG sells the major portion of this automotive glass through its own distribution outlets, the tax must presently be paid upon the wholesale price rather than upon the manufacturer's price. All of PPG's competitors pay the tax at the lower level of manufacturing since they do not own distribution outlets. This is a serious competitive disadvantage for PPG. Let me illustrate:

When a PPG competitor sells to an independent distributor, the tax falls at the level of the manufacturer's price. Thus, an article sold by a PPG competitor to an independent distributor for $10 would bear, at 8 percent, a tax of 80 cents. The distributor who has purchased the article has a cost of $10.80 and can sell it without further concern for the excise tax. If this independent distributor sells it for $20 to a dealer or retailer, the excise tax which the article bears is, nevertheless, limited to the 80 cents as determined by the price of $10 for which the article was sold to him by PPG's competitor.

In the case of PPG, however, which sells mainly through its company-owned distributing system to dealers, the tax falls on the $20. Thus, the tax to PPG is $1.60 or twice the amount paid by its competitor—the manufacturer who sells to independent distributors. The result is lack of uniformity in the tax base as between different methods of distribution, developed for good business reasons, and the imposition of the manufacturers' excise tax upon an amount which is in no proper sense a part of the manufacturer's price. This result does violence to the intent and purpose of the tax.

It is clear from the wording of the statute which applies "to the manufacturer, producer, or importer" that the intent of Congress was to tax at the manufacturer's level.

It is proposed to cure this inequity by converting the tax to a rate per square foot rather than a percentage of sales price. A tax of 12$\frac{8}{10}$ cents per square foot would yield the same revenue as 8 percent of the sale value at the manufacturing level.

The tax paid by PPG under the present law is computed at 184 separate PPG sales establishments. Under the proposal the tax would be computed at only two of its factories. Thus, the problem of the Internal Revenue Service in administration and auditing would be greatly simplified.

The proposal merely changes the computation of the manufacturers' excise tax on automotive replacement glass from a percentage of sales price to a rate per square foot and, thus, cures in our industry the inequity which has already been cured by the same method in the rubber tire industry. There is strong precedent for this method in the rubber tire industry where this same tax is computed on the basis of cents per pound rather than a percentage of sales price. (Sec. 4071 of the bill; sec. 3400 (a) of the present law.)

Submitted herewith is a draft of an amendment to section 4061 (b) which is designed to accomplish our proposal.

I am grateful, Mr. Chairman, for this opportunity to appear before your committee.

The following is the proposed amendment of section 4061 (b) of H. R. 8300 to place the manufacturers' excise tax on automotive glass on a square-foot basis rather than the present percentage of selling price. New matter is indicated by italic; omitted matter is enclosed in black brackets.

Amend section 4061 (b) to read as follows:

"(b) PARTS AND ACCESSORIES.—

(1) There is hereby imposed upon parts or accessories (other than tires and inner tubes, **[**and other than**]** automobile radio and television receiving sets *and other than automotive windshields, side windows and rear windows*) for any of the articles enumerated in subsection (a) sold by the manufacturer, producer, or importer a tax equivalent to 8 per centum of the price for which so sold, except that on and after April 1, 1954, the rate shall be 5 per centum.

(2) There is hereby imposed upon automotive windshields, side windows and rear windows for any of the articles enumerated in subsection (a) sold by the manufacturer, producer, or importer a tax at the rate of 12 and 8/10 cents a square foot so sold, except that on and after April 1, 1954, the rate shall be 8 cents.

The CHAIRMAN. Mr. Bernard F. Miller.

Make yourself comfortable and identify yourself to the reporter?

STATEMENT OF BERNARD F. MILLER, INDEPENDENT RENTAL OPERATOR OF AUTOMOBILE UTILITY TRAILERS, AND MEMBER, NATIONWIDE TRAILER RENTAL SYSTEM

Mr. MILLER. Mr. Chairman and gentlemen of the committee, my name is Bernard F. Miller. I am engaged in the business of renting automobile utility trailers, doing business as "Rent a Trailer System" in Richmond, Va., where I also reside.

I am a member of the Nationwide Trailer Rental System, an association comprised of approximately 300 independent trailer operators located in the same number of cities over the United States. I speak today for these 300 trailer operators as well as for myself.

Utility automobile trailers should not be confused with house trailers. The utility trailers that we rent to the public are usually small two-wheel open trailers, and can be readily attached to any passenger automobile. The most common size is 4 by 7 feet. Our customers are anyone who finds it necessary to move a bulky item such as extra luggage, a refrigerator, or a stove, and chooses to "do it himself" with the use of his own automobile.

Mr. Chairman, I have here some pictures so that you will see exactly the type of trailers we rent. They are all the same, sir.

The CHAIRMAN. Thank you very much.

Mr. MILLER. The manufacture of these utility trailers is a relatively simple operation requiring a minimum of capital, and one which, of course, is closely allied to the normal maintenance and repair work of the rental business. Utility automobile trailers can be readily built by rental trailer operators during slack periods, for use in their own rental business.

The problem confronting trailer rental operators is the determination of the tax base for the manufacturers' excise tax on utility automobile trailers. We are not asking for repeal of the tax, or even a reduction in the rate. We ask only for legislative clarification in H. R. 8300 to eliminate an unfair and inequitable application of the manufacturers' excise tax, which prevents the small trailer operator from building his own trailers.

When a rental trailer operator builds and sells a trailer he merely pays an excise tax on the selling price of the trailer. However, when he retains this home-built trailer for use in his own rental business, a fatal tax inequity arises. The present law provides that the "lease" of an article by the manufacturer shall be considered a taxable sale of such article, section 3440, IRC. The Internal Revenue Service has maintained that the rentals of these utility trailers for short periods of time constitute "leases"—and since leases are taxable sales, these short-term rentals are also taxable sales.

However, the Internal Revenue Service and the courts refuse to tax these short-term rentals on the same basis as taxable sales, for

example, selling price or fair market value. Instead, the excise tax is based on the total of all rental charges throughout the entire life of the trailer. Therefore, the rental-trailer operator must pay the excise tax over and over again, every time that he rents his homemade trailer.

For example, if a trailer operator buys a trailer for $100, he pays an excise tax of $10—10 percent. However, if he builds an identical trailer, he must pay the manufacturers' excise tax of 10 percent on each rental for as long as it lasts—ordinarily 10 years. The average income per year from each trailer is approximately $400—a total of $4,000 for 10 years; therefore, he eventually pays a total tax of $400 on this $100 trailer which he built himself. In other words, if he buys a trailer he pays a tax of $10; but, if he builds the trailer, he pays a tax of as much as $400.

The CHAIRMAN. Does that check with the staff?

The gentleman says if he builds a trailer himself, he eventually pays $400 in tax. If he buys one he pays about $10.

Mr. STAM. That is the way they interpret the existing law, because they tax the rental from the lease. The lease constitutes a sale under law.

The CHAIRMAN. That is a curious result.

Mr. STAM. I have discussed this with the gentleman, I think, and he has also discussed it with the Bureau.

The CHAIRMAN. Give that some good thought.

Go ahead.

Mr. MILLER. Thank you, sir.

A tax which Congress intended to be of an excise nature has been administratively and judicially altered to become a tax on gross income.

The present inequity can be corrected simply by including a definition of the term "lease" in the existing law. Section 3440 of the Internal Revenue Code and section 4217 of H. R. 8300, now provide that:

> For the purpose of this chapter the lease of an article * * * by the manufacturer * * * shall be considered a taxable sale of such article.

It should be provided that the term "lease" shall not be considered to include a mere rental where such rental is for a short period of time and dissimilar in nature to a "sale"——

The CHAIRMAN. It seems very dissimilar to me.

Go ahead.

Mr. MILLER. As in the case of the rental of utility automobile trailers by the manufacturer thereof.

Such a provision would not leave the manufacturer of utility automobile trailers untaxed. It is quite evident that where a builder of a utility automobile trailer uses it in his own trailer-rental business, he is liable for payment of the manufacturers' excise tax under still another section of the Internal Revenue Code. Section 3444—section 4218, H. R. 8300—provides that where a manufacturer produces an article for his own use, he is liable for payment of the excise tax computed on the "price at which such or similar articles are sold, in the ordinary course of trade, by manufacturers." This is an equitable basis and the basis on which the utility automobile trailer operators are more than willing to pay the manufacturers' excise tax for building their own trailers.

In other words, trailer-rental operators want to pay the manufacturers' excise tax on trailers they build, but they only want to pay the tax once, and not over and over again, dozens of times.

Virtually, no loss of revenue would result from this relief, because trailer-rental operators cannot and do not build their own trailers under the present tax law.

The tax relief that we trailer-rental operators urge your committee to include in H. R. 8300 is squarely in line with the objective of the Treasury Department, as stated by Secretary Humphrey in his statement before your committee on April 7, 1954:

> Revision to reduce hardships on individuals and barriers to incentive. * * *

Gentlemen, I respectfully thank you for this opportunity to appear before the committee.

The CHAIRMAN. We will give very careful consideration to that. Thank you for coming.

Mr. MILLER. Thank you, sir.

The CHAIRMAN. We will take a 1-minute recess.

(A short recess was taken.)

The CHAIRMAN. The meeting will come to order. Is Mr. Landis in the room?

We are very glad to have you, Mr. Landis. Sit down and make yourself comfortable and identify yourself to the reporter. We are glad to hear from you.

STATEMENT OF JAMES M. LANDIS, NEW YORK, N. Y.

Mr. LANDIS. My name is James M. Landis with offices at 230 Park Avenue, New York. I am a practicing attorney there.

Senator, with your permission, I would like to address a few remarks to section 665 to 668 of the pending tax bill.

Those sections deal with the problem of how to tax income that is accumulated by a trustee and then after a period of accumulation is turned over to the beneficiary. It is a very common provision in trusts, especially family trusts for the provision of minors and dependents, to provide that the trustee does not need to pay any or a portion of the income over to the beneficiary, except in his discretion, but charging the trustee with the duty of accumulating that income until the beneficiary reaches 21 or 25, or 31, and then paying it over to the beneficiary at that period.

The general treatment of that problem under the existing tax law is that the income which is paid over or to which the beneficiary is entitled to as of right, is taxed to the beneficiary. The income which is accumulated is taxed to the trust. So that if thereafter it is paid over to the beneficiary it would not at that time be taxed again.

Unfortunately, those trusts have been used for tax avoidance principles. You can readily see that if the beneficiary is in a higher tax bracket than the trust, that by switching around that income between the beneficiary and the trustee, that you can avoid taxes. For that reason, there is in existence today the so-called 65-day, 12-month rule. I won't bother you with that. But, that rule is not satisfactory and is recognized by all the people in the tax field that it isn't satisfactory.

Some years ago the tax section of the American Law Institute and of the American Bar Association proposed a throwback rule. In other

words, when the tax is paid over to the beneficiary, that then, for 2 years, would be treated as made upon the last day of the taxable year, and to the degree that there was income accumulated in the last 2 years and the beneficiary would pay a tax on that.

The Treasury—I think it was the Treasury—in the hearings before the House Ways and Means Committee, suggested that 2 years was not enough, and that 5 years would be a better rule.

Now, I have no quarrel with that rule at all, not the slightest. It seems to me that some rule of that nature is desirable to deal with this problem of tax avoidance. Now, tax avoidance occurs where intermittent payments are made by the trustee to the beneficiary.

The CHAIRMAN. Would you say that again?

Mr. LANDIS. Intermittent payments. I mean they may be made every 2 years or every year and a half, or they have to be at more than an interval of 1 year.

In that way, you see you gage the income to the trust and the income to the beneficiary and then you can save substantial taxes in certain cases. But the House Ways and Means Committee recognized that these trusts had a very legitimate purpose; that many times, and certainly some time ago, the tax avoidance was not the principle of establishing a trust of that nature. It was sound, conservative, and they provide in section 665, subsection (b) for an exception. The exception says that income accumulated during the period of minority will not be touched by the throwback rule. In other words, if I establish a trust for my child and the trustee accumulates income and then pays that income over to the child at age 21, the throwback rule is not applicable under the existing provisions. It is a sound exception. The only thing I suggest is that it doesn't go quite far enough. We all know, and set laws of trusts, grant laws of trusts know that children are not capable of handling money when they reach age 21. So a very common provision in these trusts is at age 25 or age 31, or at some other age when at age 21 the trustee is directed to pay over the income under those circumstances to the beneficiary. And it is my suggestion that that exception be enlarged to permit that kind of thing where there is a lump-sum payment at the end of a stated period, say, 31, 25, whatever the trust may require.

If you have that situation, it seems to me that you can have the assurance that that trust was not created, nor is it being administered for the purposes of tax avoidance, but it is being administered to carry out the wishes of the guarantor to provide an estate for the beneficiary.

It seems to me that that, if it is controlled that way, if there are intermittent payments in there I have no patience with that because that indicates to me that the administration of the trust is dominated by tax concepts rather——

The CHAIRMAN. It might not be, but it might be.

Mr. LANDIS. Yes; it might be. And I would say require a lump-sum payment at the end of the period.

It seems to be quite fair because many of these trusts go way back. Tax avoidance, as a scheme I don't think was resorted to until the heavy period of taxation, around World War II. Many of these trusts go back to 1920, and the thirties, where tax avoidance was certainly not the dominant motive.

That is my case, Senator. I have here a brief statement, and I also have a suggestion of certain language which might be of advantage

to the committee. I certainly don't hold a brief for the particular language. It is the idea I hold.

The CHAIRMAN. Have you discussed the matter with any member of the staff?

Mr. LANDIS. I have discussed the matter with a member of the staff of the joint committee.

The CHAIRMAN. We will be glad to put your statement in the record, and we are very glad to have you.

Mr. LANDIS. Thank you, sir.

(The prepared statement of Mr. Landis follows:)

MEMORANDUM ON PROPOSED TAXATION OF UNDISTRIBUTED ACCUMULATED TRUST INCOME

A common provision in trusts, particularly trusts established for the benefit of minors and dependents, allows the trustee to accumulate the annual income from the trust for a limited period, paying the beneficiary only those sums that are in the judgment of the trustee needed. The period of accumulation in some States is limited by State law to the minority of the beneficiary. Most States, however, recognize that a minor upon becoming 21 is not necessarily competent to handle money and so permit the grantor of the trust to designate some other period such as 25 or 31 as the period when the accumulated income is to be turned over to the beneficiary and the power of the trustee further to accumulate income ceases.

The general treatment of the tax aspects of these trusts has been to tax to the beneficiary the income paid to him and to tax to the trust the income that is accumulated and undistributed. When the undistributed income is later paid over to the beneficiary, such payments are then tax free since the trust has already paid the tax on that income. If the beneficiary is in a larger tax bracket than the trust, it can be seen that by accumulating income and subsequently paying it out, a substantial saving in taxes could be had. Indeed, trusts of this character have been established in recent years for this very purpose to accumulate income solely for the purpose of avoiding taxes. A simple illustration will bring this out. Suppose the net income of a trust for 2 successive years is $10,000 per year. Each year the trustee distributes only $5,000 a year to the beneficiary. The trust is then taxable on the remaining income of $5,000 a year. The beneficiary, however, may be taxable on the $5,000 per year received by him at a higher rate inasmuch as the beneficiary may have other sources of taxable income that will bring his total taxable income up far over $5,000 a year. In the third year, the trustee distributed not only all the income of the trust to the beneficiary but also the accumulated undistributed trust income of the 2 prior years of $10,000. Since the trust has already paid the tax on this $10,000, this $10,000 is not taxable to the beneficiary. Thus, by holding back certain income for a period of time and then paying it out, the beneficiary may acquire the income from the trust with a considerably less tax burden. This practice can be repeated again and again.

To meet this situation, the 65-day 12-month rule was adopted. This provides that any payment made to the beneficiary within 65 days after the end of the taxable year shall be deemed to have been made at the end of the taxable year and to the extent that such payment does not exceed the income accumulated during the past 12 months shall be taxable to the beneficiary.

This rule has not, however, dealt adequately with the situation. Tax sections of the American Law Institute and the American Bar Association and other experts suggested a new approach to the problem known as the throwback rule. This was to provide that any undistributed income would be thrown back to each of the 2 preceding years in the inverse order and would be taxed to the beneficiary to the extent that the distributable income of those years was not in fact distributed. The pending tax bill adopts this theory but increases the 2-year period to a 5-year period on the assumption that a period longer than 2 years is needed in order to close this method of tax avoidance.

This suggestion probably adequately meets the tax avoidance problem raised by these trusts, but it also places an undue tax upon trusts that were created with no thought of tax avoidance in mind and are not administered to achieve such an end.

Essential to the scheme of tax avoidance is the accumulation of income for a period of slightly over a year or more and its distribution at intervals to the

beneficiary. In this way by delaying the beneficiary's use of the income only for a short period of time and by repeating the process at appropriate intervals, a substantial tax saving can be accomplished.

On the other hand, the accumulation of trust income in certain situations has long had a legitimate and recognized purpose and should not be penalized. The House has recognized this fact. Thus in section 665 (b) of the House bill, it is provided that the throwback rule should not be applicable to accumulations of trust income during the minority of a beneficiary when such accumulations are later distributed to the beneficiary. The theory of this exception is both right and laudable. Certainly the purpose underlying the accumulation of the income in such a situation is not tax avoidance but the desire of the grantor to preserve the income not needed by the beneficiary until the beneficiary should be wise enough to handle such moneys on his own.

Unfortunately, the exception rests upon the assumption that upon becoming 21 beneficiaries are wise enough to be allowed to handle money. This we all know may or may not be true. Certainly many grantors, who may be presumed to know something about their beneficiaries, believe that 21 is too young an age for this purpose and have provided in their trust instruments that distribution of undistributed accumulated income should only be made at a later age. There are many of these trusts in existence and many of them long antedate any consideration of the impact of income-tax laws upon their establishment. They are genuine and sincere trusts. The beneficiaries until the income is actually distributed have no use of that income nor have any right to it. Nevertheless, trusts of this type are subject to the throwback rule with regard to all undistributed accumulated income, accumulated after the beneficiary becomes 21, when the beneficiary finally becomes entitled to that income.

This, it is submitted, is bringing within the scope of a rule designed to cure tax avoidance, transactions which are not dominated by that spirit. If the distribution of accumulated trust income takes place intermittently over the period say from 21 to 31 and not in a lump sum at the time when all accumulated trust income must be distributed by the terms of the trust to the beneficiary, it can be argued that a measure of tax avoidance is present because of the way in which the trust is being administered, and therefore, the throwback rule should be applied. But when a lump-sum distribution of accumulated trust income is made upon the termination of the trust or upon the vesting by the trust instrument itself of the beneficiaries' right to undistributed accumulated trust income, since such payments are not of the intermittent nature that characterize tax avoidance, the throwback rule should not be applicable. The beneficiary should not be penalized because the grantor of the trust has postponed his right to that accumulated income for a period longer than his minority.

The application of the throwback rule to these situations affects trusts which may have been established many years ago when the impact of tax legislation was of slight concern. Its retroactive effect on the administration of these trusts, who have consistently followed the grantor's directions to accumulate income until the time when the beneficiary is deemed capable of handling his own affairs, has an element of unfairness in it, for it is substantially impossible to amend these trust instruments now to permit a different pattern of accumulation. Certainly, the least that should be done is to put trust established before the advent of World War II (with its initiation of heavy taxation which inevitably stimulated tax avoidance) on a different basis.

The best approach, however, is to extend the exemption already by section 665 (b) to cases where the pattern of administration of a trust is characterized by straight accumulation followed by a lump sum payment to the beneficiary of all accumulations as of the time when the trustees' right to accumulate ceases. In such a situation it is clear that estate management in the interest of the beneficiary rather than tax avoidance dominates both the creation and administration of the trust.

The following addition to the exemption set forth in section 665 (b), it is believed, would permit the above result and still keep the throwback rule as a proper deterrent to tax avoidance:

"(3) amounts paid, credited or required to be distributed to a beneficiary in a lump sum as of the time when by the terms of the trust the right of the trustee to accumulate trust income for such beneficiary ceases and the right to receive all accumulated undistributed net income vests in such beneficiary."

The CHAIRMAN. Mr. Browne——

STATEMENT OF ROLLIN BROWNE, NEW YORK, N. Y.

Mr. BROWNE. My name is Rollin Browne, 30 Broad Street, New York City.

I want to refer, Mr. Chairman, to one very narrow feature of the bill, the feature relating to consolidated returns, and particularly the provision which governs the right of an affiliated group of corporations to change an election once made.

Since 1928, the filing of consolidated returns has been a privilege for which affiliated corporations had an election, and for which they were charged an additional or extra 2 percent tax when they exercised the election to file on a consolidated basis.

The election, once made, was binding for all years, except in certain situations, one of which was a change in the law. It was recognized that if corporations elected to file on a consolidated basis under one tax law, that should not be held binding on them when the tax law was changed, particularly when it became more burdensome.

From 1928 to 1951, for a period of over 20 years, this right to change the election, consequent upon a change in the tax law, applied whenever a new tax law became effective, irrespective of when it was enacted. In 1951 the Commissioner adopted new regulations governing consolidated returns and in those new regulations he took a new view of this particular matter, and he provided in the new regulations that the right to change, or the right to have a new election, arose from the enactment of a new tax law, irrespective of its effective date.

Now, this bill, H. R. 8300, has thrown all of the Commissioner's consolidated return regulations into the statute, has written them into the statute, and in this way the House bill would validate the new interpretation which the Commissioner placed upon this particular feature in 1951, and which was entirely inconsistent with the interpretation he had placed on the old law from 1928 to 1951.

In my prepared statement, which I have filed, I point out how objectionable that would be, and particularly how objectionable it would be where a change in the tax law is made retroactively. Where a new tax law or an amendment to the tax law is retroactive, this bill would grant a new election, as to the basis of reporting, for a year which has already been closed, even if the new tax law doesn't affect that closed year at all, but applies only to future years. And the election, the new election, which is granted by the bill as to the old year, which is closed and which is not affected by the law, that new election will bind as to all future years which are governed by the new tax law.

Now, it seems to me that that is not only illogical, but it is unfair to bind corporations for future years by the so-called exercise of an election for a year which is already closed. The only kind of an election as to the basis of reporting for tax purposes, which is a real and free election, is one which can be exercised before the end of the tax year, because in that way corporations can fit their problems of corporate management and corporate business into the basis upon which they know they are going to file their return and compute and pay their taxes.

I, therefore, urge that this bill be amended so as to return to the view which prevailed from 1928 to 1951, which granted a new election

to affiliated corporations for every year for which the tax burden was greater than for the prior year.

I may add, Mr. Chairman, that the tax committee of the American Mining Congress, I believe, has taken substantially that same position, and I think there are other groups which have called attention to this feature of the bill.

I want to thank you for the privilege of appearing before you.

The CHAIRMAN. We are very glad to have you, thank you very much.

(The prepared statement of Mr. Browne follows:)

STATEMENT SUBMITTED BY ROLLIN BROWNE

For the years 1917–21, affiliated corporations were required to file consolidated returns. The 1921, 1924, and 1926 acts gave affiliated corporations an election to file either separate returns or a consolidated return for any year beginning on or after January 1, 1922, but provided that once the election was made either way it should be binding for all later years unless the Commissioner consented to a change. However, all corporations were given a new right of election under each of those acts.

The 1928 act contained two different provisions as to consolidated returns. One applied only to the year 1928 and provided that returns for that year must be filed on the same basis as for 1927. This was justified because the tax rates for 1928 were lower than for 1927 and the 1928 act made no other change which Congress felt would materially affect affiliated corporations. The other provision of the 1928 act relating to consolidated returns applied to 1929 and later years and made radical changes in the rules. It conferred special power on the Commissioner to prescribe regulations affecting the computation of the tax on the consolidated basis, to which corporations were required to agree as a condition to filing consolidated returns. That provision gave a new election for 1929 "or any subsequent taxable year." It did not require the Commissioner's consent to change from either basis to the other, but when the Commissioner issued his new regulations he took the position that, although the statute gave affiliated corporations the right to file a consolidated return for any year, irrespective of the basis on which they had reported for the previous year, it did not say that corporations had the right to file separate returns for any year and, therefore, he had the power to provide in his regulations that if an affiliated group once elected to file a consolidated return for any year it could not file separate returns for any later years unless (1) membership of the group changed, or (2) the regulations were amended,[1] or (3) the Commissioner gave his consent.

It was conceded that, aside from the regulations, whenever a revenue act was superseded by a new and different act, or was amended so as to make the filing of consolidated returns less advantageous, taxpayers acquired a new election. The Tax Court ruled, moreover, that, whenever the tax burden was changed by any amendment of the law, whether or not to the disadvantage of consolidated returns, a new election must be allowed. This was on the fundamental principle that an election or option was involved and an election as to the method of computing one tax may not be considered binding as to the computation of a different tax. Therefore, when the Commissioner refused to allow corporations which had filed on the consolidated basis for 1932 to file on the separate basis for 1933, although the tax burden had been changed by NRA, the Tax Court overruled him in *Cereal Products Refining Corp.* (39 B. T. A. 92), saying:

"It is not material to the decision of the question before us to explore the comparative advantages or disadvantages to groups of affiliated corporations, after amendment of the 1932 act, to make consolidated returns instead of separate returns. The fact is that there was a new revenue act for the year 1933 affecting taxation of corporations. * * * It obviously became of practical importance for affiliated corporations to consider anew the method of making income-tax return for the year 1933 and to consider anew the increased rate of tax upon corporations making consolidated returns. * * * In the absence of any clear expression in the statute, as it applied to the year 1933, that Congress intended that corporation income-tax returns for 1933 should be made on the same basis as for the

[1] This clause was later changed to refer to any amendment of the law or regulations which rendered consolidated returns less advantageous.

year 1932, even though changes in the law were made * * * we must conclude that petitioner had a new election for the year 1933 because the law was changed."

To the same effect was the decision of a district court in *Belden Mfg. Co.* v. *Harrison* (C. C. H., 1940, par. 9341).

The Commissioner did not appeal either of those decisions.

Moreover, the Commissioner recognized that when a new tax law was enacted imposing different tax burdens for different future years, corporations were entitled to a new election for each of those years. For example, the Revenue Act of 1945 contained new provisions becoming effective at different dates so that the tax burden under that act differed for 1946, 1947, 1948, and 1949 tax years. Accordingly, the Commissioner announced that by reason of the enactment of the 1945 act, corporations acquired a new election as to fiscal year 1946 (I. T. 3779), the calendar year 1946 (I. T. 3794), fiscal year 1947 (I. T. 3854), the calendar year 1947 (I. T. 3880), fiscal year 1948 (I. T. 3893), the calendar year 1948 (I. T. 3923), and fiscal year 1949 (I. T. 3958). The Commissioner thereby recognized that so long as a new election depended on a change in the tax burden it arose from the change becoming effective and not merely from its enactment.

In 1951, the Commissioner amended his regulations so as to provide that the enactment of an amendment to the tax law gave corporations a new election, irrespective of when it took effect. Under this new regulation (adopted 22 years after the new scheme for consolidated returns was first enacted in 1928), the Commissioner claimed for the first time that if a new tax law was enacted in 1 year, to apply with varying effects for various future years, such new law gave corporations only one new election—as to the first return filed after the enactment of the law—and that that one election would govern all future years covered by the law even though the tax burden for each year might be different. For example, the additional tax imposed for the privilege of filing a consolidated return is 2 percent. Suppose Congress should enact a law providing that for 1955 the additional tax should be 3 percent, for 1956, 4 percent and for 1957 and later years, 5 percent. The Commissioner would say to affiliated corporations: You know now what the extra cost of filing consolidated returns will be for each year; therefore, you can decide now for all years, and you must do so; moreover, whatever you elect as to the first year you must file on the same basis for all later years. It is obvious that such a requirement would deprive taxpayers of a really free election as to 1955 and would deprive them of any election at all for any later year. And yet it is axiomatic that the income tax is imposed on an annual basis, and that each year is entirely separate and distinct from every other year, and the statute says that affiliated corporations shall have an election to file a consolidated return "for any year."

Congress made the decision long ago that the filing of consolidated returns shall be a privilege, not a requirement. This is proved by the imposition of an additional 2 percent tax for the exercise of the privilege. To continue the 2 percent charge for exercise of a so-called privilege for any year for which the taxpayers are actually required to file consolidated returns would be a great injustice.

Section 1505 (a) of the House bill incorporates the language of the regulations as amended in 1951. The Ways and Means Committee report attempts to justify the Commissioner's new position in the following language:

"Paragraph (2) of this section is intended by your committee to operate with respect to changes in subtitle A of the code whenever a return is required by law to be filed after a change in the law is made. Thus, a change in the law which occurred in January or February of one year would give rise to a right of election with regard to the return to be filed for the previous year on April 15 or such later date as the Secretary or his delegate may (by extension of time) permit. This provision has no relevance to the applicability of the change in the law or with respect to the year to which such change is first effective. The principle reflected here is a reflection of the view of your committee that the election to file returns upon a consolidated basis is a long-term decisions. Unless the law is changed, the affiliated group which elects to file a consolidated return in one year is expected to continue to file such a return for all later years. Accordingly, if a change is made, the fact that the change itself, for example, is not applicable to the year for which the next return is to be filed is not significant. For example, if the affiliated group files a return for the calendar year 1953 on September 15, 1954, the provisions of this subtitle, if enacted prior to such date, although only applicable to taxable years beginning after December 31, 1953, will provide a right to file separate returns for the

taxable year 1953 even though considated returns were filed for 1952, and even though the changes made in this subtitle have no application to the return to be filed for the taxable year 1953. As a corollary to this, a return to be filed for the taxable year 1954 must be a consolidated return if a consolidated return was filed for the taxable year 1953, even though the provisions of law applicable to the taxable year 1954 are of the type described in paragraph (2).[2]"

It is all right to say that "the election to file returns upon a consolidated basis is a long-term decision," so long as Congress enacts long-range tax legislation. But when Congress changes the tax burden from year to year it should grant taxpayers a chance to keep abreast of the kaleidoscopic changes, at least so long as it calls the filing of consolidated returns a privilege and charges an additional tax for its exercise. If consistency in tax policy is a virtue, let Congress set the example.

This requirement, first imposed by the Commissioner in 1951 and now validated by the bill, that a new election arises from the enactment of an amendment, rather than its becoming effective, is particularly unfair in the case of a retroactive amendment. As the committee report shows, this provision means that if after the close of a tax year (1953), but before returns for that year are filed, an amendment (H. R. 8600) is enacted which has no effect on returns for 1953, but which drastically changes the tax burden for later years, taxpayers will get a new election as to the one year (1953) which is not at all affected by the amendment and will not get a new election as to any of the later years which will be so vitally affected. It is appropriate to ask, in all seriousness, whether any more illogical, unfair, and viciously retroactive provision was ever written into a tax law.

The election between separate and consolidated returns cannot be exercised in vacuo; it must be exercised in the light and on the basis of known facts and conditions. The exercise of the election often has a pronounced effect on, and is often profoundly affected by, other corporate actions and decisions, many of which must be taken even before the end of the tax year. After those corporate actions and decisions have been taken during the tax year (1953, for example) and the election to file a consolidated return for that year has been made by the management, Congress cannot by subsequent legislation grant an effective new election for that year because it cannot make it possible to reverse the other corporate actions and decisions which are inextricably tied up with the election already exercised.

There are situations where an attempt to reverse prior corporate action to enable a new exercise of the election for a year already closed would be actually invalid and would subject the management to serious personal liability, as, for example, where the legality of noncumulative preferred dividends already declared and paid depended on the tax being computed on the consolidated basis. If the change in the law had been known before the end of the year the dividends could have been omitted, but they cannot later be rescinded or recovered; and if because of the later change in the law, which affects only later years, management should exercise its legal right to elect to file separate returns, thus increasing the tax, the dividends would be rendered illegal and management would be liable to the common stockholders.

Section 1505 of the House bill contains a provision which squarely conflicts with the theories advanced in the committee report. In granting a new election when the law is amended so as to make consolidated returns less advantageous, it says that the expiration of a provision of the law shall have the same effect as an amendment. Suppose that in 1954 a new provision is enacted, to take effect in 1955 and to expire in 1958. Both the amendment and its expiration are enacted in 1954. The amendment becomes effective in 1955; its expiration becomes effective in 1958. The committee says that the amendment is made in 1954 when it is enacted; yet it clearly implies that the expiration is made when it takes effect, not when it is enacted. The truth is that such an enactment in 1954 would enact two changes in the law, one becoming effective in 1955 when the enactment takes effect, and another becoming effective in 1958 when the enactment expires.

This provision of the bill, recognizing that corporations are entitled to a new election whenever the expiration of a provision of the law, substantially advantageous to the filing of consolidated returns, becomes effective, is obviously

[2] That is to say, even if the law as applicable to 1954 made it substantially less advantageous to file on a consolidated basis.

sound and demonstrates the unsoundness of the provision which states that it is the mere enactment, rather than the taking effect, of other changes in the law which justifies a new election. Moreover, the report of the Ways and Means Committee, stating that the purpose of adding this new provision to the bill was "to make it clear that the expiration of a provision of law will be a sufficient basis for the allowance of a new election" proves that the committee understood that the true meaning and intent of the existing statute is to allow a new election when a change in the law becomes effective, as the Commissioner recognized from 1928 to 1951.

It is submitted, further, that the law should allow a new election whenever an amendment of the law takes effect which materially increases the tax burden of corporations, whether or not it affects consolidated returns more seriously than separate returns. A group of corporations might be willing to pay the extra 2 percent for the privilege of filing consolidated returns if that increased their tax from 38 to 40 percent, but not if it increased their tax from 52 to 54 percent.

It is submitted that the Senate should reassert that the filing of consolidated returns is a privilege for the exercise of which taxpayers shall have a real and free election as to every year for which a materially heavier tax burden is imposed, and that it is for that privilege that they are required to pay the 2 percent additional tax.

Specifically, it is submitted that, in order to conform the bill to the true intent of existing law, section 1505 (a) of the bill should be amended so as to provide that corporations which have elected to file a consolidated return for any year may file separate returns for any subsequent year whenever—

"(2) [subsequent to the exercise of the election to make consolidated returns,] *an amendment to* subtitle A of the Code, *which substantially increases the tax burden of affiliated groups as a class filing consolidated returns, has become effective for such subsequent year,* [to the extent applicable to corporations, has been amended and any such amendment is of a character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns, regardless of the effective date of such amendment,] or".

The CHAIRMAN. Mr. Barta. Sit down and be comfortable and identify yourself to the reporter.

STATEMENT OF A. K. BARTA, SECRETARY-TREASURER, THE PROPRIETARY ASSOCIATION

Mr. BARTA. My name is A. K. Barta. My office is at 810 18th Street, here in Washington, and I am secretary-treasurer of the Proprietary Association. This is a trade association of about 150 companies that manufacture drugs and medicines.

To conserve the time of the committee, I also speak for other trade associations who are affected by certain sections of the bill. I have filed with the clerk for the record a statement of my own, one of the American Drug Manufacturers Association, and one for the Lambert Pharmacal Co.

The CHAIRMAN. They will be made a part of the record.

(The statements referred to follow:)

STATEMENT OF A. K. BARTA, WASHINGTON, D. C., IN RE H. R. 8300, SECTIONS 5331, 5647, AND 5131 TO 5134, INCLUSIVE

Mr. Chairman and members of the Finance Committee, my name is A. K. Barta; my office is at 810 18th Street, here in Washington, and I am the secretary-treasurer of the Proprietary Association. This is a trade organization of approximately 150 companies manufacturing and marketing packaged drugs and medicines. I also speak for other national trade associations whose member companies are affected by several sections of H. R. 8300. They are: The Interstate Manufacturers Association, the Flavoring Extract Manufacturers Association, the American Pharmaceutical Manufacturers Association, and the American Drug Manufacturers Association.

I wish to address my remarks to the subject of distilled spirits industrially used and the taxes thereon.

Through piecemeal legislation, the laws pertaining to distilled spirits and industrial alcohol, like Topsy, just grew. This resulted in many inconsistencies which the proposed revision in H. R. 8300 seeks to eliminate. But if H. R. 8300 is enacted as now written, greater inconsistencies, ambiguities, and hardships will result with respect to the commercial or industrial use of alcohol.

It might interest you to know the First Congress of the United States struggled with the problem of taxes on distilled spirits. The second law passed by the First Congress on July 4, 1789, levied a duty of 10 cents per gallon on distilled spirits of Jamaica proof and of 8 cents per gallon upon all other distilled spirits. During the second session of the same Congress, these taxes were increased. And during the third session of the First Congress, on March 3, 1791, the first tax on domestic distilled spirits was levied. From that day to this, there has been more or less confusion respecting taxes on distilled spirits.

Much of this confusion arises from the failure to clearly distinguish between spirits used as beverages, and alcohol used industrially. Such a distinction has been attempted, for you will find in section 5002 of H. R. 8300 a definition of distilled spirits generally as meaning ethyl alcohol commonly produced by the fermentation of grain, starch, molasses, or sugar. In section 5319 of the bill alcohol is defined as meaning ethyl alcohol from whatever source or whatever processes produced. Treasury Regulations 3, article IV, section 182.6, pertaining to industrial alcohol try to make this distinction clear by the following language:

"(a) 'Alcohol' means that substance known as ethyl alcohol, hydrated oxide of ethyl, or spirits of wine, from whatever source or process produced, having a proof of 160 degrees or more, but does not include the substances commonly known as whisky, brandy, rum, or gin, or other spirits, produced at registered distilleries for fruit distilleries operated under Bureau of Internal Revenue Regulations 4 and 5."

To further the distinction, the same regulations define a "registered distillery" as meaning a distillery established or operated under the regulations governing the production of distilled spirits, other than alcohol produced pursuant to these regulations.

Now the words "distilled spirits" and "alcohol" have been used interchangeably because as new laws were passed no clear distinction was made between the two. However, if you will associate the words "distilled spirits" with whisky, and the word "alcohol" with an industrial chemical, some of the fog will be lifted.

At the turn of the century registered distilleries were the only legal units distilling spirits for beverage use and the small quantities of alcohol used by industry. There was no tax-free alcohol at this time. However, foreign nations—notably Germany—were using alcohol extensively in industry and in the production of power, heat, and light. To keep pace and assist American industry, Congress in 1906 passed the Denatured Alcohol Act providing for the withdrawal of alcohol from bond tax free for industrial use. Paraphrased, section 1 of the Denatured Alcohol Act provided that:

"Domestic alcohol * * * may be withdrawn from bond without the payment of internal revenue tax, for use in the arts and industries, and for fuel, light, and power, provided said alcohol shall have been mixed * * * with * * * denaturing material or materials * * * suitable to the use for which the alcohol is withdrawn, but which destroys its character as a beverage and renders it unfit for liquid medicinal purposes; such denaturing to be done on the application of any registered distillery in denaturing bonded warehouses * * *".

This identical section of the 1906 law is today section 5331 (a) of H. R. 8300. Observe the language clearly prevents the use of denatured alcohol in liquid medicines as well as in beverages.

Shortly after passage of the 1906 act, the Commissioner of Internal Revenue ruled that sulfuric ether could not be manufactured from denatured alcohol because it was a liquid medicine. Congress then amended the law on March 2, 1907, to except ether and chloroform, which are liquid medicines, from the provisions just quoted.

Nothing much happened until the Tariff Act of 1913 authorized a new system for the manufacture of alcohol for denaturation only by "industrial distilleries." This act did not require alcohol to be denatured so as to be unfit for liquid madicines. The alcohol was required to be "rendered unfit for use as an intoxicating beverage by an admixture of such denaturing materials as the Commissioner" might prescribe. Because of economic conditions no industrial distilleries or denaturing plants came into being until about 1916, so that from 1906 to 1916 denatured alcohol could not be used in liquid medicines.

However, under the provisions of the 1913 law, the Commissioner first authorized use of denatured alcohol in a liquid medicine (a liniment) on October 6, 1916. This was followed with authorization for the use of denatured alcohol in tincture of iodine, later liquid soap.

By 1919, industrial distilleries were producing more alcohol for denaturation than were the registered distilleries, and the business of the latter was terminated with the National Prohibition Act.

Title III of that law, relating to industrial alcohol, provided only that alcohol be denatured so as to be "unfit for use as an intoxicating beverage." Section 5303 of H. R. 8300 also provides that alcohol from industrial alcohol plants shall be denatured so as to be "unfit for use as an intoxicating beverage." Note carefully there is no requirement that industrial alcohol also be denatured so as to be unfit for liquid medicines. Further, section 19 of title III of the National Prohibition Act provided:

"All prior statutes relating to alcohol as defined in this title are hereby repealed insofar as they are inconsistent with the provisions of this title."

Now considering the fact registered distilleries from 1919 on made no alcohol for denaturation, plus the repeal provision just quoted, plus the prohibition in section 5194 of the bill which provides that spirits produced in a registered distillery may not be withdrawn for denaturation, plus the procedures adopted by the Bureau of Internal Revenue, it would appear the 1906 act was no longer in effect.

Not so, said the Treasury Department. We will continue this provision in the law, but under authority of title III of the Prohibition Act, alcohol may be specially denatured and used in the production of liquid medicines. We find in section 5303 that alcohol produced in industrial-alcohol plants need be denatured only to the extent it is "unfit for use as an intoxicating beverage." Our procedure, said the Treasury, shall be first: Alcohol withdrawn from an industrial plant shall be denatured so as to be unfit for use as an intoxicating beverage. Second, it may be withdrawn and denatured with materials suitable to the end use of the product. Thus there grew up the present-day list of special formulas for denaturing alcohol to be used in medicines as well as for all other industrial purposes.

Under the 1919 law the drug and medicines industry began the use of specially denatured alcohol in liquid medicines, although this was prohibited by the 1906 law. But remember that section 19 of the 1919 law said "all prior statutes relating to alcohol as defined in this title are hereby repealed insofar as they are inconsistent with the provisions of this title."

Now it was clear. Denatured alcohol could be used in the production of liquid medicinal preparations. Then the drug and medicines industry and the Bureau of Internal Revenue were confronted with a problem unforeseen and not covered by law. In what kind of liquid medicinal preparations could denatured alcohol be used without making a beverage use of the product possible? Industry cooperated with the Government, and after many conferences and discussions, the late Dr. Doran issued his famous Adam's apple rule.

Dr. Doran was a man of great ability, endowed with much commonsense. His rule was simple: "That liquid medicine which goes below the Adam's apple must contain tax-paid ethyl alcohol. For all other external uses specially denatured alcohol may be used." This rule in part is found in Treasury Regulations section 182.864 reading as follows:

"Medicinal preparations and flavoring extracts used for internal purposes may not be manufactured with specially denatured alcohol where any of the alcohol remains in the finished product."

Both Government and industry have observed the Adam's-apple rule for the past 35 years.

Now comes H. R. 8300, which will be the new Internal Revenue Code under which we must live. It provides in section 5331 the provisions of the 1906 law, which prohibits the use of specially denatured alcohol in liquid medicinal products. It provides in section 5303 the provisions of the 1919 law that industrial alcohol need be denatured only so as to be "unfit for use as an intoxicating beverage." And it provides in section 5310 that alcohol may be withdrawn free of tax for denaturing "as provided by existing law." Thus far it would seem possible to continue in the future just as we have in the past.

But something new has been added. The report of the House Committee on Ways and Means states with respect to section 5310 that:

"The provisions of subsection (a), which provide that alcohol produced at any industrial alcohol plant or stored in any bonded warehouse may, under regulations, be withdrawn tax free, as provided by 'existing law,' from such plant or warehouse for transfer to a denaturing plant for denaturation, make applicable to such alcohol, when withdrawn for denaturation, the provisions of section 5331. The term 'existing law' in subsection (a) is intended to include 'section 5331.'

"The penalty contained in section 5647, relating to the unlawful use or concealment of denatured alcohol, is applicable to alcohol produced in industrial alcohol plants and withdrawn for denaturation since all such alcohol is withdrawn under the provisions of section 5331."

That is bad enough, but reading further from the House report in connection with section 5331, we find this language:

"This section is existing law. * * *

"The language contained in this section is substantially in the form in which it was originally enacted in 1906, as amended in 1907.

"This section is intended to apply to alcohol produced at industrial alcohol plants and withdrawn for denaturation."

So we have here a new bill, the provisions of which are explained in the accompanying report and the interpretations therein place us back under the law of 1906, when denatured alcohol could not be used for "liquid medicinal purposes." Officials of the Alcohol and Tobacco Tax Unit of the Internal Revenue Service state this was not the intent of the revision, and that it was assumed there would be no change in existing operations. If this be true and the status quo is to be maintained, then a minor amendment to two sections of the bill is all that is necessary.

First, in section 5331 of the bill, within the phrase "renders it unfit for liquid medicinal purposes" insert the word "ingestive" so that as amended the phrase will read "renders it unfit for ingestive liquid medicinal purposes."

And in the penal section of the bill (sec. 5647) preceding the phrase "liquid medicinal preparation" insert the word "ingestive."

With these simple amendments, it is believed the status quo will be maintained and the use of specially denatured alcohol continued in the production of liquid medicinal preparations intended for external use. These amendments would write into the law clear authorization for a practice which has been in existence for the last 35 years.

PART II—SECTIONS 5131 TO 5134, INCLUSIVE

Sections 5131 to 5134 of the bill relate to the nonbeverage use of distilled spirits or alcohol. Medicines intended for ingestive or internal use, and many food products such as flavors and flavoring extracts must be produced with ethyl alcohol upon which a tax must be paid. This is a continuation of the Adam's-apple rule, and in line with Treasury regulations section 182.864 which prohibit the use of specially denatured alcohol in any medicinal preparations and flavoring extracts used for internal purposes.

Recognizing this necessary use of spirits as compared with the luxury or beverage use, Congress provided that qualified manufacturers upon proof satisfactory to the Treasury Department, might make a claim for drawback of a portion of the taxes paid. On the whole this procedure has been satisfactory, and it is the apparent intent of H. R. 8300 to continue the operation of the drawback system.

But again the revision proposed in H. R. 8300 if enacted as written will work an undue hardship upon the nonbeverage user of ethyl alcohol. Section 5005 of the bill makes the domestic distilleries and proprietors of industrial alcohol plants liable for the tax, and so today the tax on spirits or alcohol is paid at the time of withdrawal. However, something new has been added in section 5061 of the bill, which provides that the taxes on distilled spirits shall be paid by return, with authority given the Secretary to prescribe the period for which the return shall be filed, the time for filing, and the time for payment of the tax determined.

This is a relief to which the distillers are entitled, but in practice will work a hardship upon the nonbeverage user unless he, too, is given consideration in connection with the return method of tax payment. The report of the House committee in this connection states:

"Section 5131. This section is existing law. It should be observed that the requirement that alcohol must be 'fully taxpaid' to be eligible for drawback has been continued in this section. Although it will be possible for distilled spirits

or alcohol to be removed from bond and used upon determination of the tax and before payment of the tax, regulations to be prescribed under the provisions of this section will require that the tax be paid prior to the payment of drawback claims in order that the Government will not be placed in the position of acting favorably upon a claim for refund prior to the actual payment of the tax to be refunded."

This means the nonbeverage user of ethyl alcohol must pay the internal-revenue tax at the time of withdrawal, which payment is made to the distiller. The latter files with the Treasury a return of taxes due the Government, but does not pay over the nonbeverage user's tax money until the due date fixed between the Secretary and the distiller. In the meantime the nonbeverage user has processed the alcohol and makes his drawback claim. This claim will not be paid because the distiller has not yet turned the tax money over to the Treasury Department.

To remedy this injustice, the nonbeverage user of alcohol should also be placed on a return basis. In practice, this would work out with the nonbeverage user being given the same grace period as that given the distiller before payment of taxes due.

This problem has been discussed with representatives of the distillers and with officials of the Alcohol and Tobacco Tax Unit, and agreement has been reached with respect to simple amendments to be made in sections 5131 and 5132, as follows:

Wherever the words "and fully taxpaid" occur, substitute the words "and on which the tax has been determined."

In section 5134 (a) strike out the word "taxpaid" and insert in lieu thereof the words "on which the tax has been determined": and in section 5134 (a) (1), (2), and (3), strike out the word "paid" and insert in lieu thereof the word "determined."

The adoption of these amendments will permit the Treasury Department to honor a drawback claim showing the amount of tax determined to be paid, whether or not it has yet been received by the Department. There would be no loss of revenue to the Treasury, inasmuch as all parties liable to the Government are under bond.

It is hoped the Finance Committee will see the justice and need for the amendments to H R. 8300 herein suggested and will approve of them, noting the reasons therefor in the report of the committee.

AMERICAN DRUG MANUFACTURERS ASSOCIATION,
Washington, D. C., April 22, 1954.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: On behalf of the legislative section of the American Drug Manufacturers Association, we wish to comment on the provisions of H. R. 8300 relating to denatured alcohol for industrial use. The member firms of this association are the leading manufacturers of pharmaceutical products for the medical and allied professions. A membership list is attached.

Under the present Internal Revenue Code and the regulations of the Treasury Department, drug products which are not taken into the digestive tract of the body may be made with specially denatured alcohol. Some examples of products falling in this category are surgical antiseptics, household antiseptics (such as tincture of iodine), rubbing alcohol, mouthwashes, lotions, and certain ointments. The use of tax-free alcohol in these medicinals has been the practice for many years, and is justified by the fact that the alcohol in no way serves as a beverage or as a physiological agent, but is used solely for its physical properties. It usually serves merely as a solvent. This use does not differ from other legitimate industrial uses of alcohol, and it is therefore consistent to classify it as a permitted industrial use.

The practice of using tax-free alcohol for antiseptics, mouthwashes, and similar products enables these essential medicinals to be sold at much lower prices to the public than would be the case if tax-paid alcohol were employed. Since these products are regularly used by many people in the lower income groups, it is desirable to produce them as economically as possible.

The American Drug Manufacturers Association hopes that the present practice of employing tax-free alcohol for these limited medicinal uses will not be changed when the Internal Revenue Code is revised. However, under the present wording

of section 5331 of H. R. 8300, and especially when certain statements in the House committee report on H. R. 8300 are brought into the picture, there is a real danger that the present practice in this field will be inadvertantly altered.

Section 5331 of H. R. 8300 states in part "Domestic alcohol * * * may be withdrawn from bond without the payment of internal revenue tax, for use in the arts and industries, and for fuel, light, and power, provided such alcohol shall have been mixed * * * with methyl alcohol or other denaturing material or materials, or admixture of the same, suitable to the use for which the alcohol is withdrawn, but which destroys its character as a beverage and renders it unfit for liquid medicinal purposes;". When this wording is read in conjunction with the statements in the House committee report referring to the Internal Revenue Act of 1906 (which was enacted before specially denatured alcohol was permitted for antiseptics, mouthwashes, etc.), there arise questions as to the possibility of the present practice being discontinued if H. R. 8300 is passed without changing section 5331.

The American Drug Manufacturers Association respectfully recommends that the word "ingestive" be inserted in section 5331 of H. R. 8300, so that the last portion of the quotation given above would read "renders it unfit for liquid ingestive medicinal purposes." This simple amendment would make it clear that the present practice of using tax-free alcohol for antiseptics, rubbing alcohol, mouthwashes, and similar products can be continued. It would not extend the use of tax-free alcohol to areas where it is not now permitted, since the phrase "unfit for liquid ingestive medicinal purposes" would carry with it the meaning that any medication which is swallowed, thus being ingested, must contain tax-paid alcohol.

The word "ingestive" is also needed in the appropriate places in the penalty section, section 5647, of H. R. 8300.

It is our earnest hope that these simple but important changes in H. R. 8300 will be made by your committee.

Sincerely yours,

KARL BAMBACH,
Executive Vice President.

MEMBERS OF THE AMERICAN DRUG MANUFACTURERS ASSOCIATION

Abbott Laboratories, 14th Street and Sheridan Road, North Chicago, Ill.
Ames Co., Inc., Elkhart, Ind.
The Armour Laboratories, Armour & Co., 520 North Michigan Ave., Chicago, Ill.
Ayerst Laboratories, Division of American Home Products Corp., 22 East 40th Street, New York, N. Y.
J. T. Baker Chemical Co., Phillipsburg, N. J.
Bauer & Black, Division of the Kendall Co., 309 West Jackson Boulevard, Chicago, Ill.
E. Bilhuber, Inc., 377 Crane Street, Orange, N. J.
Bristol Laboratories, Inc., 630 Fifth Avenue, New York, N. Y.
Buffington's Inc., 8 Sudbury Street, Worcester, Mass.
Burroughs Wellcome & Co. (U. S. A.) Inc., Tuckahoe 7, N. Y.
W. J. Bush & Co., Inc., 19 West 44th Street, New York, N. Y.
G. W. Carnrick Co., 20 Mount Pleasant Avenue, Newark, N. J.
Ciba Pharmaceutical Products Inc., 556 Morris Avenue, Summit, N. J.
Cole Chemical Co., 3721–27 Laclede Avenue, St. Louis, Mo.
Commercial Solvents Corp., 1331 South First Street, Terre Haute, Ind.
Cutter Laboratories, Fourth and Parker Streets, Berkeley, Calif.
Davies, Rose & Co., Ltd., 22 Thayer Street, Boston, Mass.
Difco Laboratories Inc., 920 Henry Street, Detroit, Mich.
Distillation Products Industries, Division of Eastman Kodak Co., 729 Ridge Road W., Rochester, N. Y.
The Dow Chemical Co., Midland, Mich.
Fine Chemicals Division, American Cyanamid Co., post-office box 550, Bound Brook, N. J.
Fritzsche Bros., Inc., 76 Ninth Avenue at 15th Street, New York, N. Y.
Gelatin Products Division, R. P. Scherer Corp., 9425 Grinnell Avenue, Detroit, Mich.
Heyden Chemical Corp., 342 Madison Avenue, New York, N. Y.
Hoffmann-La Roche, Inc., Roche Park, Nutley, N. J.
Hyland Laboratories, 4501 Colorado Boulevard, Los Angeles, Calif.
Hynson, Wescott & Dunning, Inc., 1030 North Charles Street, Baltimore, Md.
Johnson & Johnson, 501 George Street, New Brunswick, N. J.

Lakeside Laboratories, Inc., 1707 East North Avenue, Milwaukee, Wis.
Lederle Laboratories Division, American Cyanamid Co., 30 Rockefeller Plaza, New York, N. Y.
Eli Lilly & Co., 740 South Alabama Street, Indianapolis, Ind.
Lloyd Bros., Inc., 1016 Mound Street, Cincinnati, Ohio
Lloyd & Dabney Co., Inc., 412 Central Avenue, Cincinnati, Ohio
Magnus, Mabee & Reynard, Inc., 16 Desbrosses Street, New York, N. Y.
Mallinckrodt Chemical Works, Second and Mallincrodt Streets, St. Louis, Mo.
Maltbie Laboratories, 240–250 High Street, Newark, N. J.
McNeil Laboratories, Inc., 2900 North 17th Street, Philadelphia, Pa.
Mead Johnson & Co., St. Joseph Avenue and Ohio Street, Evansville, Ind.
Merck & Co., Inc., 126 Lincoln Avenue, Rahway, N. J.
The Wm. S. Merrell Co., Cincinnati, Ohio
Monsanto Chemical Co., 1700 South Second Street, St. Louis, Mo.
The National Drug Co., 4663–85 Stenton Avenue, Philadelphia, Pa.
The New York Quinine & Chemical Works, Inc., 50 Church Street, New York, N. Y.
The Norwich Pharmacal Co., 17 Eaton Avenue, Norwich, N. Y.
Parke, Davis & Co., Joseph Campau at the River, Detroit, Mich.
The E. L. Patch Co., 38 Montvale Avenue, Stoneham, Mass.
S. B. Penick & Co., 50 Church Street, New York, N. Y.
Chas. Pfizer & Co., Inc., 11 Bartlett Street, Brooklyn, N. Y.
Pitman-Moore Co., Division of Allied Laboratories, Inc., Post Office Box 1656, Indianapolis, Ind.
A. H. Robins Co., Inc., 1407 Cummings Drive, Richmond, Va.
Schering Corp., Bloomfield, N. J.
G. D. Searle & Co., Post Office Box 5110, Chicago, Ill.
Sharp & Dohme, Division of Merck & Co., Inc., 640 North Broad Street, Philadelphia, Pa.
Sherman Laboratories, 14600 East Jefferson Avenue, Detroit, Mich.
Smith, Kline & French Laboratories, 1530 Spring Garden Street, Philadelphia, Pa.
Carroll Dunham Smith Pharmacal Co., 401 Codwise Avenue, New Brunswick, N. J.
E. R. Squibb & Sons, Division of Mathieson Chemical Corp., 745 Fifth Avenue, New York, N. Y.
R. J. Strasenburgh Co., 195 Exchange Street, Rochester, N. Y.
Tailby-Nason Co., 49 Amherst Street, Cambridge, Mass.
The Upjohn Co., Kalamazoo, Mich.
Valentine Co., Inc., 1600 Chamberlayne Avenue, Richmond, Va.
Henry K. Wampole & Co., Inc., 440 Fairmount Avenue, Philadelphia, Pa.
Warner-Chilcott Laboratories, Division of Warner-Hudnut, Inc., 113 West 18th Street, New York, N. Y.
White Laboratories, Inc., Kenilworth, N. J.
The Wilson Laboratories, Division of Wilson & Co., Inc., 4221–25 South Western Avenue Boulevard, Chicago, Ill.
Winthrop-Stearns, Inc., 1450 Broadway, New York, N. Y.
Wyeth Laboratories, Division of American Home Products Corp., 1401 Walnut Street, Philadelphia, Pa.
The Zemmer Co., Inc., 3943 Sennott Street, Pittsburgh, Pa.

Memorandum Suggesting Amendments to Provisions as to Taxability of Denatured Alcohol To Avoid Possibility That a Tax May Be Imposed With Respect to Denatured Alcohol Not Taxed Under Present Law

This memorandum is submitted on behalf of the Lambert Co., which manufactures and sells Listerine antiseptic. This is a liquid medicinal preparation for use in the oral cavity, on the scalp and on the skin. This well-known preparation has been marketed for 70 years. The product is formulated in part with specially denatured alcohol, which the company uses under permits issued by the Treasury Department.

Under existing law the specially denatured alcohol so used is not subject to the gallonage tax on alcohol. It is our understanding that neither Congress nor the Treasury Department intends that the proposed legislation result in the imposition of any such new and destructive tax. The form of the proposed enactment, however, might give rise to this question, which can and should be avoided by the simple clarifying change suggested at the conclusion of this memorandum.

HOW THE PROBLEM ARISES

H. R. 8300 would reenact, substantially without change, the provisions of existing statutes defining denatured alcohol and regulating the withdrawal and sale of such alcohol free of tax. In doing so, it would reenact, by section 5331 (a) (1), an obsolete definition of denatured alcohol first adopted in 1906. This definition has been modified by subsequent legislation and is inconsistent with other provisions of existing statutes and with present administrative construction thereof. It is also inconsistent with the definition of denatured alcohol set forth in section 5303 of the proposed code.

DISCUSSION

The provision which presents the problem, section 5331 (a) (1), provides in part:

"Domestic alcohol * * * may be withdrawn from bond without the payment of internal revenue tax, for use in the arts and industries * * * provided such alcohol shall have been mixed * * * with methyl alcohol or other denaturing material or materials * * * suitable to the use for which the alcohol is withdrawn, but which destroys its character as a beverage and renders it *unfit for liquid medicinal purposes;* such denaturing to be done on the application of any registered distillery in denaturing bonded warehouses * * *." [Emphasis supplied.]

This language is in substantially the same form as it was enacted by section 1 of the Denatured Alcohol Act of 1906 and as it now appears in IRC section 3070 (a).

The effect to be given to IRC section 3070 (a) is limited by title III of the National Prohibition Act, enacted October 28, 1919. Title III of this act created a complete system for the production, storage, and denaturation of industrial alcohol. It provided for the establishment of industrial alcohol plants, and for the establishment of denaturing plants to be used exclusively for the denaturation of alcohol "by the admixture of such denaturing materials as shall render the alcohol, or any compound in which it is authorized to be used, *unfit for use as an intoxicating beverage.*" [Emphasis supplied.]

The quoted provision, which is presently contained in IRC section 3102 and is carried forward in section 5303 of the proposed code, sets forth the only requirement for denaturation established by title III of the National Prohibition Act, viz, that the alcohol be rendered unfit for use as an intoxicating beverage. There was no requirement that alcohol also be denatured so as to render it unfit for liquid medicinal purposes. Section 19 of title III of the National Prohibition Act provided:

"All prior statutes relating to alcohol as defined in this title are hereby repealed insofar as they are inconsistent with the provisions of this title."

The regulations adopted by the Treasury Department following the enactment of the National Prohibition Act apply only a requirement that denaturation render alcohol unfit for use as an intoxicating beverage. For example, section 182.673 of the regulations defines denatured alcohol as follows:

"Denatured alcohol is ethyl alcohol to which has been added such denaturing materials as render the alcohol unfit for use as an intoxicating beverage. Denatured alcohol is divided into two classes, namely, completely denatured alcohol and specially denatured alcohol, prepared in accordance with approved formulas prescribed in the 'Appendix to Regulations 3.' "

Numerous formulae for specially denatured alcohol have been approved, all of which render the alcohol unfit for intoxicating beverage purposes. Some of these formulas (e. g., formula No. 37) are designed for use in liquid medicinal preparations.

Similarly, section 182.836 of the regulations provides in part:

"Liquid products containing specially denatured alcohol must be unfit for use as beverages or for intoxicating liquor purposes, and must not be readily convertible into potable alcohol by simple distillation or manipulation."

Again, section 182.858 of the regulations provides in part:

"A manufacturer * * * shall not sell rubbing alcohol compound for use, or for sale for use, for beverage purposes, nor shall he sell such product under circumstances from which it might reasonably appear that it is the intention of the purchaser to procure the product for use, or for sale for use, for beverage purposes."

Reenactment of the provisions of the 1906 act as section 5331 (a) (1) of the proposed code, however, might be interpreted as intended to ignore the legislative changes subsequent to 1906, as well as the administrative construction of the subsequent legislation and the now prevalent use of denatured alcohol in medicines other than those for internal use. If it were actually the intent of Congress that alcohol must be denatured so as to render it unfit for any liquid medicinal purposes, as well as for use as an intoxicating beverage, the present use of denatured alcohol in medicines other than internal medicines would become impossible. Further, the use in such medicines of undenatured alcohol subject to tax would be economically ruinous.

It is believed that Congress actually intends no such far-reaching and destructive change in the existing law. Rather, the possible consequences of reenactment of the 1906 definition of denatured alcohol appear to be inadvertent, through failure to reflect the operation of title III of the National Prohibition Act in repealing prior inconsistent provisions.

SUGGESTED AMENDMENTS

1. That section 5331 (a) (1) of the proposed code be amended by inserting the word "ingestive" immediately before the word "liquid" appearing at the end of the last line on page 586, so that the phrase will read "renders it unfit for ingestive liquid medicinal purposes" instead of reading "renders it unfit for liquid medicinal purposes."

(Webster's New International Dictionary (2d edition) defines "ingest" as "To take in for digestion, as into the stomach.")

2. That section 5647 of the proposed code, dealing with penalties, be amended by inserting the word "ingestive" immediately before the words "liquid medicinal preparation" in line 7 of such section 5647 as set forth on page 614 of H. R. 8300, so that the phrase will read "ingestive liquid medicinal preparation."

We understand that the amendments suggested above will also be urged by representatives of the Proprietary Association and other interested trade associations.

Respectfully,

THE LAMBERT CO.,
PHILIP E. GREGG, *Counsel.*

NEW YORK 22, N. Y.

Mr. BARTA. The other groups I speak for are the Interstate Manufacturers Association, the Flavoring Extract Manufacturers Association, the Fruit & Syrup Manufacturers, and the National Association of Beverage Flavorers. Also, the American Pharmaceutical Manufacturers Association, and the American Drug Manufacturers Association.

There are two sections in the bill which vitally affect our respective industries and their member companies. The first section is section 5331, which is a reenactment of the section 1 of the Denatured Alcohol Act of 1906.

It might interest you to know that there has been for years and years confusion respecting the tax on distilled spirits. The second law passed by the First Congress of the United States levied a tax on distilled spirits, and we have had trouble ever since. But in 1906 Congress, to keep pace with what was going on abroad, passed the Denatured Alcohol Act, to make alcohol available for the arts and industries and the production of heat, power, and light. And that law said that alcohol, to be so used, had to be denatured so as to destroy its characteristic as a beverage and be unfit for liquid medicinal purposes.

Now that, of course, prohibited the use of denatured alcohol in any liquid medicinal preparation.

In 1907 Congress had to amend that law so as to provide for the production of ether and chloroform, and from that time, up until 1916 no denatured alcohol could be used in a medicine.

In 1913 Congress, to encourage the use of alcohol and to provide relief for the farmers, provided for the construction and operation of industrial alcohol plants. None came into being because they placed a limit of 100 gallons a day production. And with alcohol selling for about 25 cents, it wasn't feasible. But that law said that alcohol had to be denatured only to be unfit for intoxicating beverage purposes. It made no mention of medicinal preparations.

In 1916 the Commissioner of Internal Revenue, operating under that law, then authorized the use of denatured alcohol in a liniment. But nothing much happened until 1939, when the National Prohibition Law was enacted, and that law provided that insofar as alcohol was concerned, all laws and parts of laws not consistent therewith, were repealed, and it provided that alcohol, to be used industrially had to be denatured first; that it was not fit as an intoxicating beverage. And they stopped there.

So, under that law, the Bureau of Internal Revenue permitted the drug and medicine industry to use ethyl alcohol, specially denatured so that it would be fit for use for the end product. But it was not a beverage use, and we have been operating under that law for 15 years, since 1939 up to date, and many formulas have been approved by the Treasury Department.

Section 5331 is a repetition of the Denatured Alcohol Law of 1906. Sections 5303 and 5310 of the present bill reenact the language of the 1919 law. So, if it was just the language, I presume we could operate as we have in the past. However, the report of the House committee on this bill changes the picture entirely. In that report they state that the provision of section (A)—and I am now talking about section 5310 of the law under which we are operating—the provisions of this subsection which provide that alcohol produced at any industrial alcohol plant make applicable to such alcohol when withdrawn for denaturation, the provisions of section 5331, and that is the 1906 law.

Then, when you read under section 5331, the report states that this section is existing law, and I admit all that, but it says:

> This section is intended to apply to alcohol produced at industrial alcohol plants and withdrawn for denaturation.

So, they put us right back under the 1906 law when they say no denatured alcohol could be used in a liquid medicinal preparation.

The CHAIRMAN. Was that the purpose?

Mr. BARTA. The Treasury said that was not the purpose.

Mr. STAM. The idea was not to change existing law. They just incorporated into the new act the existing provisions. And in the code of 1939, this 1906 act, as well as the prohibition provision which the gentleman refers to, were both incorporated.

Now, I think the position that these gentlemen take is that there is going to be an enactment into law. We are getting up an entirely new code. Now the 1939 code was not to change existing law, and I think they are afraid that the way this is set up that there might be some construction placed in this code to change existing practice. That was not intended, and we are going to try to see if we can't do something about it.

Mr. BARTA. I have talked it over with everybody that is affected in the industry, and we are perfectly willing to leave the language in if

you will insert one word. In section 5331, where it says that it must be rendered unfit for liquid medicinal purposes, if you will insert the word "ingestive," it will then read that it will be rendered unfit for ingestive medicinal purposes.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Mr. BARTA. Industry has gone along under this unwritten Adam's apple rule for years, that pure ethyl alcohol is that which goes below the Adam's apple, and specially denatured alcohol is used elsewhere.

The CHAIRMAN. I think the staff will make some attempt to clarify that.

Mr. BARTA. I have one other section in which the industry is interested—well, several sections: Sections 5131 to 5134, inclusive.

Because of this Adam's apple rule we have to use alcohol in food products and medicines that are used internally, and Congress, to provide—up until the time of the war we had to pay the same tax on that alcohol as was paid on beverage alcohol. Congress, to give us some relief, set up a drawback system whereby we pay the full tax and then make a claim and get all back but $1, today. The language of the law is just exactly the same as we are operating under now, but again the report of the committee sets up a little difficulty for us, and that comes about by an amendment to the bill which permits the distiller, who is responsible to the Government for the tax, or the proprietor of an industrial alcohol plant, to be liable to the Government for the tax. He is the only one.

So, we pay our tax at the time of withdrawal, and it goes to the distiller. He, in turn, turns it over to the Treasury.

The provision in section 5005 of the bill permits the distiller to make a return of taxes due the Government, not that he must pay them at the time, and the Secretary will fix the period for which he files his statement and the date on which he pays his taxes.

So, if we buy alcohol, say, on the 20th of the month, process it and make our drawback claim on the first, it is possible the distiller's return date is not until the 15th of the month, so we will not get our money.

And the report of the House committe states that—

> Regulations to be prescribed under the provisions of this section will require that the tax be paid prior to the payment of drawback claims.

Now, we have turned our money into the distiller, but the distiller hasn't turned it over to Uncle Sam. This problem I have discussed quite thoroughly in the Alcohol and Tobacco Unit, and with representatives of the distillers, and the consensus is there is pretty good agreement that we should be given the same kind of relief, on a return basis.

So, in the sections to which I refer, wherever the language "fully tax paid" occurs, it is suggested to be amended to say, "on which the tax has been determined." Then the distiller will give us a form, and that form we can file with our claim, so that this much money is coming in and they will pay it forthwith.

The CHAIRMAN. What about that, Mr. Stam?

Mr. STAM. We are looking into that. We have had that question come up, and we are talking to the Bureau people about it now.

Mr. BARTA. Now, down in the Treasury they think that is a pretty reasonable amendment.

That is all I have, and I want to thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Gutkin. Sit down and be comfortable, Mr. Gutkin, and identify yourself to the reporter.

STATEMENT OF SYDNEY A. GUTKIN, ATTORNEY, NEWARK, N. J.

Mr. GUTKIN. Mr. Chairman, I am appearing here in my capacity as professor of tax law at Rutgers University——

The CHAIRMAN. Would you mind repeating what you said?

Mr. GUTKIN. I am appearing here as professor of taxation at Rutgers University School of Law, which is the State University of New Jersey.

The CHAIRMAN. What State university?

Mr. GUTKIN. Rutgers University, which is the State university of New Jersey.

I am also here in my capacity as a practicing tax lawyer.

We have given consideration to various aspects of the bill, and have many thoughts concerning it. However, we know that you have heard many of the thoughts that we would otherwise express, expressed by others, so I am confining my remarks to one point that has not been discussed as far as I know. I hope that it will help to remedy a situation that we have felt, in the course of our academic discussions and practical applications of our academic views, requires remedying.

Senator FLANDERS. Mr. Chairman, I wonder if the witness would raise his voice.

Mr. GUTKIN. I am sorry, sir. I neglected to look around this way.

The CHAIRMAN. Pretend you are talking to a classroom.

Mr. GUTKIN. I was addressing myself simply to the chairman, and I apologize.

Some of the things I think that have not been discussed at considerable length are the provisions concerning the administrative and adjective aspects of the bill, rather than the substantive aspects of the bill. In that connection, I should like to refer to the statute of limitations in criminal fraud cases, the substance of which was originally contemplated by Congressman Simpson's bill, H. R. 5048 of the 82d Congress, 1st session, and H. R. 3431 of the 83d Congress, 1st session, which passed the House and died in the Senate.

I understand from the committee reports that the bill of Congressman Simpson had the approval of the Treasury, was not opposed by the Department of Justice, and would have become the recommendation of the Senate Finance Committee had proper circumstances developed.

I am acquainted with some of the background of it, and I don't think it is helpful or needful to discuss that. At this time, however, I think there is no reason why the substance of Congressman Simpson's bill should not be incorporated in the revision, inasmuch as the main aspects have already been incorporated, and our only question is with respect to the effective date.

The CHAIRMAN. Give me the substance of the bill.

Mr. GUTKIN. As you may recall, the period of limitation on criminal prosecutions is 3 years, in the case of some offenses, and 6 years in the case of other offenses.

The statute goes on to say that the statute is tolled during the absence of the defendant from the judicial district where the crime was committed. That has given rise to much litigation. It has been the subject of much discussion in our law school. It is a wonderful thing to discuss and academically we find many intriguing examination questions based upon venue, whether absence means you can be absent from a place if you were never in a place.

And the courts are confronted with the problem. There are varying decisions. Apparently the courts are coming to the view that the statute at the present time should be interpreted in accordance with the way the present bill would seek to handle the situation, whether or not that is a proper interpretation of the law.

The CHAIRMAN. That is good judicial practice.

Mr. GUTKIN. Common judicial practice, may I say.

At any rate, the bill would remedy the situation. It would set at rest the——

The CHAIRMAN. What would the bill do?

Mr. GUTKIN. The bill would provide that the statute of limitations is not tolled and would continue to run, except if the taxpayer is outside of the United States or is a fugitive from justice.

We believe that the statute doesn't go quite far enough, although it does help to remedy the situation. Congressman Simpson's bill originally would have made the nonrunning of the statute coextensive with the lack of jurisdiction of the Federal courts. In other words, if a man were outside of the United States, or if he were a fugitive from justice, the running would be tolled. And this bill adopts the same principle, except, however, that it confines the running of the statute to places where the taxpayer is within the United States, as defined in the bill.

We feel, although this isn't particularly important, but I think is in line with correct practice, that the statute should run against a taxpayer wherever he may be in the world, provided we have the jurisdiction over him by our courts. That would mean not only the Territories of Alaska and Hawaii, but Puerto Rico, the Virgin Islands, and all those places where our courts could exercise jurisdiction over him.

The proposed revision is a step in the right direction. It should go a little further. But the main substance of my discussion this morning centers around the effective date of the provision.

Under section 7851 of H. R. 8300, subparagraph (D) provides that it shall only apply to prosecutions and offenses after the date of the enactment of the title.

Now, the net effect of that would be that the remedial legislation planned by section 6531 would not be effective until the year 1961.

And the reason I say that is this: If it would only apply to offenses taking place after the enactment, it would only apply to returns filed March 15, 1955, or later. The 6-year statute of limitations applicable to March 15, 1955, will run to March 15, 1961. So that the provision is completely abortive and does not remedy the thing that it was designed to remedy.

It is our suggestion that the limitation provision be expanded to provide that—

> The amendments made by section 6531 shall apply with respect to offenses committed on, before, or after the date of the enactment hereof, except that such amendments shall not apply to any offense (1) for which the period of

limitations in effect prior to the enactment of this act expired on or before the date of such enactment—

And that is to save the possible argument that the statute of limitations may be opened by this provision—

or (2) with respect to which the indictment is found or the information is instituted on or before March 8, 1954.

That, we thing, would remedy this entire situation and eliminate all of the litigation that has been going on in the last few years, which is plaguing the courts and certainly us in a practical and academic manner.

With your indulgence, I might refer to the fact that this entire subject matter has developed most recently. The statute was not much involved in litigation up until the last 5 or 6 years. Recently we have had a great many cases on this point. We have a conflict between the second circuit in New York, and the decisions in the third circuit in New Jersey—by the way, not in the appellate courts, but in the district court of the United States, as to when a man is absent or present in a particular place. It is all very confusing. And I think that this provision, when coupled with some of the venue provisions in the new bill, will make even more litigation in our Federal courts and, far from solving this problem, will only make it more serious.

One other comment: We have felt that there is a considerable constitutional question concerning the present law as it is now in the present code. A question which has not been argued in the courts, and has not been passed on, is as to whether or not it is constitutional to provide that the statute shall run against a resident in the State of New York or New Jersey, or other parts of the country, and shall not run with respect to the residents of one-third of all of the counties of the United States.

At the present time, for example, just to illustrate, if a person resides in—or, just before a change in some of the administrative practice, if a person resided in the Bronx, he was required to file his return in Albany. His judicial district where he resided in the Bronx was different from the judicial district of Albany. Therefore, the Department of Justice argued that he was absent from the district where he filed the return, and, therefore, there was no statute of limitations.

Without laboring the point, I trust that I have made my point on this. I don't know that my recommendation would be in the slightest opposed by the Treasury Department. As a matter of fact, Congressman Simpson's bill originally had the approval of the Treasury.

The CHAIRMAN. It died here in this committee because we figured that it was opening up some doors to shady characters at that time.

Mr. GUTKIN. Yes. I think probably, however, the necessity for having it die has also died at this time.

In a few of those cases, if my impression is correct, the courts have already done what the bill would have done. In other words, we had the Beard case decided by the District Court for the District of Maryland most recently, where one of the persons I think the committee might have had in mind lived in the District of Columbia. And he filed his return as he was required to do, in Baltimore. The statute would have barred prosecution if applicable. If it had been tolled, indictment would have been proper.

The Department of Justice argued that the indictment was proper, inasmuch as the defendant was not in Maryland. The District Court for the District of Maryland dismissed the indictment and said in order to be absent from a place, you must first be there.

The CHAIRMAN. It makes a little sense, doesn't it?

Mr. GUTKIN. It sounds so to me. Otherwise, if that were not so, I should think that the statute might well be held, if so interpreted, to be unconstitutional. And that is one of the things we have in mind that we should like to avoid.

There are a few other provisions, or one other that I think merits some attention. I just want to mention it, if I may, in passing, and that is with respect to the powers of the Tax Court of the United States. I think they merit some attention of the Congress.

The Tax Court of the United States has the power to subpena a witness to testify. If a witness refuses to appear, there is no way by which he can be punished, as for a contempt. The Tax Court has no power. As a result of that, if a sophisticated individual wishes to make abortive the process of the court and to impede the determination of a case, he may simply fail to honor the subpena of the court and then the only alternative that the court or the litigants have would be to apply to the district court of the United States for an order to enforce compliance of the subpena.

Under those circumstances, the case must either be continued, or else the taxpayer or Government counsel must run the risk of going ahead with the trial of the case, without having that witness testify.

I submit that something should be done to make enforceable the process of the Tax Court under those circumstances.

The CHAIRMAN. Have you discussed the matter with anybody in the Tax Court?

Mr. GUTKIN. Yes; I have discussed the matter, and the court feels very much that way.

The CHAIRMAN. The court feels that way?

Mr. GUTKIN. Very much so.

The CHAIRMAN. The Tax Court, as you know, has gone through considerable evolution since the time it started.

Mr. GUTKIN. Yes, sir.

The CHAIRMAN. And, at one time it was intended to keep it under very, very sharp limitations.

Mr. GUTKIN. Yes, sir.

The CHAIRMAN. But I think it needs some broadening of that concept.

Mr. GUTKIN. Well, I think that at the present time it is really and truly a court, and should be treated as such.

If I may, with your indulgence, submit a proposed modification of subsection (d) of section 7851 of the proposed Revenue Code, I should like to do so.

The CHAIRMAN. It will be made a part of the record.

Mr. GUTKIN. Thank you very much.

The CHAIRMAN. Thank you.

(The proposed modification referred to follows:)

STATEMENT IN SUPPORT OF TESTIMONY OF SYDNEY A. GUTKIN, ESQ.

THE STATUTE OF LIMITATIONS IN CRIMINAL FRAUD CASES

Section 3748 of the Internal Revenue Code makes provision for a period of limitations of 3 years for offenses arising under the internal revenue laws, except that the period shall be 6 years for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof.[1] The statute further provides that the time during which the person committing any of the offenses is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of the proceedings.[2] It is this latter provision which has given rise to litigation, confusion, and the need for legislative action.

(a) The problem

Section 53 (b) (1) of the code provides that returns of individuals shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Md.[3] Thus, the offense of filing a false or fraudulent tax return or of failing to file a return is deemed to have been committed at the place where the return was or should have been filed.[4] There is no question that the word "district," as used in section 53 (b) (1) means "collection district" and the word "district," as used in section 3748 has generally been thought to mean "judicial district."[5] There is a serious question as to when a person is "absent" from the judicial district.

For example, residents of the District of Columbia are required to file returns of income in the collection district office at Baltimore, Md.[6] Since they and the collection office in which such returns are filed are not located within the same judicial district, the problem arises as to whether such taxpayers are "absent" from the district. If so, they would not be able to avail themselves of the statute of limitations during any such absence. The problem is particularly acute because the residents of almost one-third of the counties in the United States must file their returns in collection districts other than the judicial district.[7]

The problem is, of course, not present in a State such as New Jersey, where there are 2 collection districts and only 1 judicial district. Whether the crime

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[1] 26 U. S. C. A., sec. 3748: The full text of this portion of the statute is as follows: "No person shall be prosecuted, tried, or punished, for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within 3 years next after the commission of the offense, except that the period of limitation shall be 6 years—

"(1) for offenses involving the defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not, and in any manner,

"(2) for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof, and

"(3) for the offense of willfully aiding or assisting in, or procuring, counseling, or advising, the preparation or presentation under, or in connection with any matter arising under, the internal-revenue laws, of a false or fraudulent return, affidavit, claim, or document (whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document)."

For civil purposes, there is no limitation period where a false return, or no return, has been filed (26 U. S. C. A., sec. 276 (a)).

[2] 26 U. S. C. A., sec. 3748: This portion of the statute provides, in terms, as follows: "For offenses arising under sec. 37 of the Criminal Code, March 4, 1909, 35 Stat. 1096 (U. S. C., title 18, sec. 88), where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof, the period of limitation shall also be 6 years. The time during which the person committing any of the offenses above mentioned is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings. Where a complaint is instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district."

[3] 26 U. S. C. A., sec. 53 (b) (1).

[4] *Bowles* v. *U. S.* (73 F. (2d) 772 (4th Cir. 1934)); see also *U. S.* v. *Beard* (— F. Supp. — (D. Md. 1954), reported at 1954 P–H Fed. Tax Survey, par. 72, 327); cf. *U. S.* v. *Albanese* (— F. Supp. — (S. D. N. Y., 1954), reported at 1954 P–H Fed. Tax Serv. par. 72, 352).

[5] See Senate Finance Report No. 1507, 82d Cong., 2d sess., on H. R. 5048, p. 2; see *U. S.* v. *Beard*, note (4) supra.

[6] *Bowles* v. *U. S.*, note (4), supra.

[7] The Treasury Department has reported that this situation exists with respect to residents of 945 out of 3,070 counties in the country. Hearings before Ways and Means Committee, 83d Cong., 1st sess., pt. 2, General Revenue Revision, p. 1357.

is committed in either of the collection districts, it will necessarily fall within the single judicial district.[8] The problem would arise if the New Jersey taxpayer should, during the limitations period, remove his residence to another State and, accordingly, another judicial district. But, suppose, however, that the taxpayer continues his principal place of business within the judicial district of New Jersey. Is it not arguable that he has not absented himself from the judicial district?

(*b*) *The cases*

Although the aforementioned statute of limitations provisions were first passed in 1884[9] they were not, so far as can be ascertained, judicially considered until 1935.[10] Since the latter date, these provisions have frequently been before the district courts of the United States but apparently not directly before any appellate tribunal. A recent decision, in this area is *United States* v. *Beard*, decided on January 26, 1954.[11]

The defendant in the Beard case was indicted for evasion of income taxes on three counts. The indictment was filed on January 29, 1952; the return alleged to be false under the first count had been filed on January 15, 1946, which was 6 years and 14 days prior to the filing of the indictment. Defendant moved to dismiss the first count of the indictment, on the ground that the period of limitations had expired before the filing of the indictment.

The facts showed that the defendant had resided in the District of Columbia continuously for more than 40 years; that from January 15, 1946, to January 29, 1952, he was away from his home in the District of Columbia for business and pleasure not more than 2 or 3 days at a time and that such absences were only natural and normal and without intent to interfere with or hinder the investigation or prosecution of the case. The court noted that as a resident of the District of Columbia, which was within the collection district of Maryland, the defendant was legally obliged to file his income-tax return there and could be prosecuted for a false return only in the judicial district of Maryland.[12] It is to be noted that under the Federal Rules of Criminal Procedure, the prosecution shall be had in a district in which the offense was committed.[13] Accordingly, prosecution in the wrong district is fatal to the Government's case.

The Government's contention was that because the defendant had never resided in Maryland, he had been "absent" from the judicial district and accordingly, the statute had tolled during the period of such absence. The court concluded that the legislative history of the statute, as well as a reasonable construction thereof, indicated that the word "absent" should be interpreted to mean that defendant "absented" himself from the judicial district.[14] Accordingly, defendant's motion to dismiss the first count of the indictment was granted.

Earlier decisions by the various district courts have created many areas of doubt in this connection, and conflict with each other. On the authority of *United States* v. *Mathis*,[15] a resident of the district of New Jersey who leaves the district for normally short periods for business or recreation would not be absenting himself from the jurisdiction so as to toll the statute. On the other

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[8] For a comprehensive treatment of collection and judicial districts in all States and Territories of the United States, see Wolfram, Harold W., "Tolling the Statute of Limitations in a Criminal Tax Case: A Supplement," Taxes, the Tax Magazine, July 1950, p. 609 et seq.

[9] As originally proposed in Congress, the tolling provision was applicable only "to persons beyond the reach of legal process." See note, 66 Harv. L. Rev. 1323 (1953). When introduced, the measure carried with it the recommendation of the Commissioner of Internal Revenue, 15 Congressional Record 3097, endorsed by the Secretary of the Treasury, which stated in part as follows: "I respectfully suggest that Congress be requested to enact a statute fixing the limitation for the prosecution of offenses against the revenue laws at a much less period than 5 years, as now provided by law, except in cases where the accused *places himself beyond the jurisdiction of the district* where the offense is committed." [Italics supplied.] Wolfram, "Tolling the Statute of Limitations in a Criminal Tax Case," Taxes, the Tax magazine, January 1950, p. 54, footnote 11. In a separate letter, the Secretary of the Treasury stated: "A proviso excepting cases in which the accused places himself beyond the jurisdiction of the proper court should be inserted in the bill." Ibid.

[10] *U. S.* v. *Anthracite Brewing Co. et al.*, 11 F. Supp. 1018 (N. D. Pa., 1934).

[11] Note (4), supra.

[12] Note (4), supra

[13] Federal Rules of Criminal Procedure, rule 18.

[14] The Court stated: "If considered merely lexicographically it seems inapt to say that a person who has never resided in a certain judicial district is absent from that district. For illustration—a child who has never been entered at a school would not properly be marked as absent from school. But more importantly, I think the history of the legislation indicates that the word 'absent' in this particular statute was intended to be used in the sense of one who is in some way evading criminal process as by absenting himself from his usual residence."

[15] 28 F. Supp. 582 (D. N. J. 1939).

hand, a resident of the southern district of New York, leaving the district under similar circumstances, has been held to be "absent from the district." [16] Apparently to the contrary is the recent decision in *U. S.* v. *Altruda*, decided by the southern district of New York.[17] The district of New Jersey and the southern district of New York are, moreover, in conflict on the question whether a nonresident alien is "absent" from the district if he files, or is required to file, a return from abroad and remains outside the district. The New Jersey District Court has held that under such circumstances the statute was not tolled; [18] the southern district of New York has held to the contrary.[19]

In *United States* v. *Satz*,[20] defendant was indicted for filing a false return. More than 6 years had elapsed between the filing of such return and the indictment. The return was filed in Albany, which is in the northern district of New York, although defendant resided in the Bronx, which is in the southern district of New York. Shortly after filing the return, defendant moved to California. On motion to dismiss the indictment, the motion was denied, on the ground that the defendant had been "absent from the district." It should be noted that the defendant had never resided in the northern district, but that he had been absent from both the collection district and the judicial district by reason of his removal to California. And in *United States* v. *Udell*,[21] the defendant was a resident of Delaware (which has one collection and one judicial district) at the time when the return was filed, but thereafter and within the 6-year period established his residence elsewhere. The statute was held to have tolled.

It would seem that the approach of the *Beard* case is desirable. The legislative history of the statute of limitations discloses that it was originally held to have tolled in cases where the defendant was "beyond the seas" or "fleeing from justice." [22] The standard should be compatible with the "fleeing from justice" standard with which the courts have long been familiar in nonincome tax Federal crimes.[23] Certainly, the crime of income-tax evasion involves no more moral turpitude than most other crimes, and involves less flight from justice than most others. It has been recognized that the statute of limitations should be construed liberally in favor of defendants,[24] even by those courts which have not done so.[25] Recent proposals of legislation introduced in Congress are predicated on the "fleeing from justice" concept.[26]

(*c*) *Constitutional questions*

The Constitution of the United States guarantees to all persons due process [27], which has in some cases been held to include equal protection of law. Does the statute grant equal protection to all persons if the population of almost one-third of all the counties in the country would be deprived of its sanctuary? [28] Although it could be argued that persons who voluntarily remove themselves from the judicial district in which they resided at the time when the crime was committed have by their own act deprived themselves of the protection of the statute, there would seem to be no justification for such deprivation where such

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[16] *U. S.* v. *Frankel* (26 A. F. T. R. 1114 (S. D. N. Y. 1939)), not officially reported.

[17] At the time of writing, the foregoing case had not been reported. However, it appears from telephonic conversations with the office of the United States attorney, Southern District of New York, that the indictment had been returned on November 16, 1953, charging willful intent to defeat and evade income taxes for the years 1945, 1946, and 1947. The defendant had made 5 trips to Europe and was out of the country 917 days during the 6-year period of limitations. On motion to dismiss, it was held that the statute of limitations had not been tolled during taxpayer's absence. Judge Connor held that there had been no showing of intent on the part of the taxpayer to change his domicile or residence.

[18] *U. S.* v. *Eliopoules* (45 F. Supp. 777 (D. N. J. 1942)).

[19] *U. S.* v. *Patenotre* (81 F. Supp. 1000 (S. D. N. Y. 1948)).

[20] 109 F. Supp. 94 (N. D. N. Y. 1952).

[21] 109 F. Supp. 96 (D. Del. 1952).

[22] As was pointed out by Judge Chestnut in *U. S.* v. *Beard*, note (4), supra, the "most familiar of the early British statutes regarding limitations was the Statute of 21, James I, ch. 16 (1623), which, in certain civil suits tolled the running of the statute in favor of the plaintiff who was 'beyond the seas'; and by the Statute of 4, Anne (1705), ch. 16, s. 19, the statute of limitations was also tolled in certain civil suits against defendants who go 'beyond the sea.' The earliest Federal statute of limitations with regard to criminal offenses was the act of 1790, 2d sess., ch. 9, sec. 32, 1 Stat. 119, which provided that limitations should be tolled where the defendant was 'fleeing from justice'; and this is in substance the same expression which is now used in a similar connection in the general Federal limitation statutes with respect to criminal actions."

[23] 18 U. S. C. 3290 (Supp. 1952) cited in note, 66 Harv. L. Rev., note (9), supra.

[24] See *U. S.* v. *Scharton* (285 U. S. 518 (1931)).

[25] See *U. S.* v. *Satz*, note (20), supra, and *U. S.* v. *Udell*, note (21), supra.

[26] See topic entitled "Proposed Legislation," sec. XXXE (1), infra.

[27] Constitution of the United States, fifth amendment.

[28] See note (7), supra.

is not the case. Nor does it sem that sufficient consideration has been given to this facet either in the published literature or the cases.[29]

(*d*) *Venue*

So far as can be ascertained, the relationship of venue to the statute of limitations has not been considered. The recent decision in *U. S.* v. *Albanese*[30] has brought the problem into sharp focus.

In the Albanese case, defendants moved to dismiss two counts of an indictment charging them with attempting to defeat and evade income taxes under 26 U. S. C. A. section 145 (b). The ground urged for dismissal was that the offenses were "not alleged to have been committed in the southern district of New York." Count I charged that the defendant willfully attempted to defeat and evade his 1947 income tax "by willfully preparing and causing to be prepared and mailed in the southern district of New York" a false and fraudulent return, which was filed with the collector of internal revenue at Albany, N. Y. Count III charged that the defendants (husband and wife) willfully attempted to defeat and evade 1949 income tax "by preparing and causing to be prepared and mailed in the southern district of New York" a false and fraudulent return which was filed with the collector of internal revenue at Albany, N. Y. Defendant contended that since the returns were filed in Albany, the offense, if any, was committed there and prosecution should have been had in that judicial district (northern district) in accordance with rule 18, Federal Rules of Criminal Procedure.[31]

The court noted that section 145 (b) does not make filing the essential element constituting the offense and a successful prosecution under that section does not require the filing of a false return. Rather, said the court, the section punishes fraudulent conduct which comprise "attempts in any manner to evade or defeat any tax." The court further noted that the acts of filing the false returns alleged in counts I and III were but the final steps in the fraudulent attempts committed in the southern district to defeat or evade the tax. Relying on title 18, United States Code Annotated, section 3237, which provides that "any offense against the United States begun in one district and completed in another, or committed in more than one district, may be inquired of and prosecuted in any district in which such offense was begun, continued, or completed," the court ruled that affirmative acts constituting "attempts" to defeat and evade had occurred in the southern district of New York, and consequently the indictments were properly found. In denying defendants' motion, the court recognized the possibility that the filing of a false and fraudulent return might constitute the attempt to defeat and evade the tax, the inference being that an indictment might also have been found in the northern district.

This decision poses serious problems from the aspect of the statute of limitations. Although the statute was not involved in the Albanese case, its facts may be considered to represent a typical situation. It may be assumed that the defendants were at all times present within the judicial district of the southern district of New York, and at no time present within the judicial district of the northern district of New York. Thus, if the indictment were found in the southern district because the offenses charged were wilfully preparing, causing to be prepared, and mailing, a false return, and said offenses were there committed, the statute of limitations would not be tolled during the period between the commission of the offense and the return of the indictment. If, on the other hand, the indictment had been found in the northern district of New York, because the offense charged was the filing of a false and fraudulent return, and said offense was committed in the northern district of New York, the Department of Justice would argue that the statute of limitations would have tolled during the period between the commission of the offense and the return of the indictment.[32] Inas-

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[29] Although this constitutional objection was raised on a motion in *U. S.* v. *Udell*, note (21), supra, the district court avoided it. It may well be that the court's action was based on the fact that the defendant absented himself from the judicial district, and accordingly, the court may have considered the defendant not in a position to raise the objection.

[30] Note (4) supra.

[31] Rule 18. DISTRICT AND DIVISION. Except as otherwise permitted by statute or by these rules, the prosecution shall be had in a district in which the offense was committed, but if the district consists of two or more divisions the trial shall be had in a division in which the offense was committed.

[32] It is to be noted that as of July 1, 1953, Bronx County, which was formerly in the territory of the district director of internal revenue, Albany, in the northern judicial district, was transferred to the territory of the district director of internal revenue, Upper Manhattan, and in the southern judicial district.

much as the commission of a section 145 (b) offense is normally a progressive one, involving the preparation and filing of a false and fraudulent return with intent to defeat and evade tax, and inasmuch as section 3237 of title 18, United States Code Annotated, above quoted, provides for an election of district for prosecution where the offense is committed in more than one district, may it not be argued that the Government may be in a position to control the statute of limitations by a judicious selection of the district for the bringing of an indictment? Of course, in a case such as *U. S.* v. *Beard*,[33] the statute of limitations having run, the option would not be available.

Let us suppose that affirmative acts have been undertaken in the posting of false invoices, the keeping of false books and records, and the preparation of a false return. Suppose, further, that the return is mailed in the District of Columbia, but never arrives at the collection office in Maryland. Since it has already been seen that failure on the part of a resident of the District of Columbia to file an income tax return in Maryland constitutes an offense in Maryland,[34] it could be argued, based upon the Albanese decision, that an indictment would be properly found in either jurisdiction. It is questionable whether a separate indictment would lie in each of the judicial districts, on the theory that a separate offense was committed in each such district.

If a taxpayer knows that he is about to remove his residence and business to California, and recognizes that he may be held to be absent from the judicial district of New Jersey if he prepares and files a false and fraudulent return with the district director of internal revenue at Newark prior to his departure, can he select his own forum by preparing and filing such return in California even though it be a later return?[35]

New provisions regarding venue in criminal prosecutions have been proposed, and are hereinbelow discussed.

(*e*) *Proposed legislation*

H. R. 8300 contains the following provisions:

(1) *Statute of Limitations.*—Section 6531 of the bill, which deals with the periods of limitations on criminal prosecutions[36] provides, in part, as follows:

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[33] Note (4), supra.

[34] *Bowles* v. *U. S.*, note 4, supra.

[35] Although sec. 53 (b) (1) of the code provides that returns of individuals shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, there is some indication through dictum that this provision is neither jurisdictional nor mandatory, but only directory. See *U. S.* v. *Dallas National Bank et al.* (152 F. (2d) 585 (5th Cir., 1945)). If this indication is correct, would not the statute of limitations run in his favor while he resided in California? It is interesting to note that language appeared in H. R. 5048, note 39, infra, as follows: "If any person, in the course of committing any offense in respect of a tax imposed by ch. 1 or ch. 2, files a return under such chapter in a collection district knowing that such district is not a collection district in which the filing of such return is prescribed pursuant to law, the period of limitations prescribed by this subsection for such offense shall not commence to run in respect of such person until whichever of the following is the earlier: (*a*) The day on which such return is received in the office for a collection district in which the filing of such return is prescribed pursuant to law, or (*b*) the day on which there is received in the office for such a district a notice from such person stating when, and in which district, he filed such return." This provision does not appear in the currently proposed H. R. 8300.

[36] This portion of the bill broadens the scope of sec. 3748 (a) of the code. (See note 1, supra) The first paragraph thereof provides as follows: "No person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information instituted within 3 years next after the commission of the offense, except that the period of limitation shall be 6 years—

"(1) for offenses involving the defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not, and in any manner;

"(2) for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof;

"(3) for the offense of willfully aiding or assisting in, or procuring, counseling, or advising, the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a false or fraudulent return, affidavit, claim, or document (whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim or document);

"(4) for the offense of willfully failing to pay any tax, or make any return (other than a return required under authority of pt. III or subch. A of ch. 61) at the time or times required by law or regulations;

"(5) for offenses described in secs. 7206 (1) and 7207 (relating to false statements and fraudulent documents);

"(6) for the offense described in sec. 7212 (a) (relating to intimidation of officers and employees of the United States);

"(7) for offenses described in sec. 7214 (a) committed by officers and employees of the United States; and

"(8) for offenses arising under sec. 371 of title 18 of the United States Code, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof."

"The time during which the person committing any of the various offenses arising under the internal revenue laws is outside of the United States or is a fugitive from justice within the meaning of section 3290 of title 18 of the United States Code, shall not be taken as any part of the time limited by law for the commencement of such proceedings."

This provision would clarify the law and would eliminate many of the niceties and technicalities of construction with which the courts have been concerned. It would seem apparent that in cases such as *United States* v. *Eliopoulous*[37] and *United States* v. *Patenotre*,[38] the statute would be tolled during the time when the taxpayers were living in Europe. This provision would also eliminate the troublesome problem of whether a person must have at some time been present within the district in order to be absent from it, or whether such absence can be found even though the person was never present within the district. It seems equally apparent that most, if not all, situations involving absence from the judicial district by a person who remains within the continental confines of the United States would be resolved. Emphasis would unquestionably shift to whether such person was "a fugitive from justice." Although the question might prove troublesome in a case in which the taxpayer removed himself from the judicial district where the crime was committed and took up residence elsewhere, the determination would seem to offer no greater obstacle to resolution than now exists in the resolution of any other question of fact. Inasmuch as the process of the Federal Government reaches throughout the country, the proposed measure provides all of the necessary safeguards.

What is meant by the "United States," as used in section 6531? Reference to section 7701 (a) (9) of the bill discloses that the term "United States" when used in a geographical sense "includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia." Predecessors of the bill had incorporated the definition of "United States" within the statute of limitations provision, and had embraced the foregoing as well as "the possessions of the United States, and the Canal Zone" within the term.[39] It is submitted that the definition should be coextensive with the jurisdiction of the United States to execute a warrant for the arrest of any person for any of the offenses referred to or described in the section.[40] Furthermore, the current bill differs from its antecedents in that there are no exceptions for persons absent from the United States by reason of active service as a member of the Armed Forces of the United States, nor are provisions set forth concerning the filing by a taxpayer of a return in a collection district "knowing that such district is not a collection district in which the filing of such return is prescribed pursuant to law."[41] Finally, the current bill provides that where a complaint is instituted before a Commissioner of the United States within the limitations period, said period shall be extended to a date 9 months after the filing of such complaint. The law as it now stands is that where a timely complaint has been instituted before a Commissioner, the limitations period is extended until the discharge of the grand jury at its next session within the district.

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[37] See note 18, supra.

[38] See note, 19, supra.

[39] See H R. 5048, 82d Congress, 1st session, introduced by Congressman Simpson in the House of Representatives on August 2, 1951, passed by the House on October 19, 1951, and thereafter referred to the Senate, approved by the Secretary of the Treasury by letter to Senator George dated January 15, 1952, and reported favorably by the Senate on May 1, 1952. (See S. Rept. No. 1507, 82d Cong., 2d sess., footnote 5, supra.) Because of the adjournment of Congress, no definitive action was taken on this measure, which amended the statute of limitations provision to read as follows: "The running of the period of limitations prescribed by this subsection for any offense shall be suspended in respect of a person committing such offense for any time during which such person is not present in the United States; except that there shall be no such suspension under this sentence for any time during which such person is not present in the United States by reason of active service as a member of the Armed Forces of the United States. The term 'United States,' when used in the preceding sentence in a geographical sense, means the States, the Territories of Alaska and Hawaii, the District of Columbia, the possessions of the United States, and the Canal Zone. If any person, in the course of committing any offense in respect of a tax imposed by chapter 1 or chapter 2, files a return under such chapter in a collection district knowing that such district is not a collection district in which the filing of such return is prescribed pursuant to law, the period of limitations prescribed by this subsection for such offense shall not commence to run in respect of such person until whichever of the following is the earlier: (A) the day on which such return is received in the office for a collection district in which the filing of such return is prescribed pursuant to law, or (B) the day on which there is received in the office for such a district a notice from such person stating when, and in which district, he filed such return." Congressman Simpson reintroduced the measure in the House as H. R. 3431, at the 83d Congress, 1st session, on February 24, 1953. Said bill was substantially the same as H. R. 5048 but omitted all reference to the filing of returns in an erroneous collection district.

[40] See S. Rept. 1507, note 5, supra.

[41] Note 39, supra.

The effective date of section 6531 of the bill is governed by section 7851 (d) which provides: "All periods of limitation, whether applicable to civil causes and proceedings, or to the prosecution of offenses, or for the recovery of penalties or forfeitures, hereby repealed shall not be affected thereby, but all suits, proceedings, or prosecutions, whether civil or criminal, for causes arising, or acts done or committed, prior to said repeal, may be commenced and prosecuted within the same time as if this title had not been enacted." It is quite clear that the new statute of limitations provision is, on its face, prospective only. If it were judicially determined to be prospective only, it is to be questioned whether such a result would be desirable or even justified in the light of its judicial history and the evils which the legislation was designed to remedy.[42] It may well be that the provision should in great part be held to be mainly declaratory of existing law.[43] It is the view of the writers that if this provision becomes law in 1954, and is to be of any help with respect to any cases arising before March 15, 1961, it should be made retroactive.

(2) *Venue.*—Section 7494 of the bill,[44] which is entirely new in scope in our internal revenue laws, is designed to apply in cases in which the taxpayer resides in one judicial district while the internal revenue office where he is required to file his return, pay his tax, or supply information, is located in another judicial district.[45] In such case, if the taxpayer uses the United States mail to send the payment, return, or other document to the internal revenue office, and, if he deposits the matter in the United States mail in the judicial district of his residence, that act will have the same consequence for the purpose of determining the venue as the payment of the tax or filing of the return or other document in an internal revenue office. Thus, where the taxpayer posts his return in his own judicial district, such act would seem to require the Government to seek an indictment in the judicial district of the taxpayer's residence, thereby starting the limitations period. However, if the taxpayer does not use the mails at all, or if he uses the mails but posts his return in a different judicial district from that in which he resides, it would seem that his position is no better than it is under current law.

Where the taxpayer fails to pay a tax, or make or file any return, the bill provides that such failure shall be deemed to have occurred in the judicial district of the taxpayer's residence, thereby starting the limitations period. This would seem to change the rule enunciated in *Bowles* v. *U. S.*,[46] in which the court held that failure to file a return by a resident of the District of Columbia constituted an offense in the judicial district of Maryland.

RECOMMENDATION BASED UPON TESTIMONY OF SYDNEY A. GUTKIN, ESQ., NEWARK, N. J.

It is recommended that subsection (d) of section 7851 of the proposed Internal Revenue Code of 1954 (H. R. 8300) dealing with the effective date of periods of limitation, be amended to read as follows:

"(d) PERIOD OF LIMITATION.—*Except as herein provided to the contrary*, all periods of limitation, whether applicable to civil causes and proceedings, or to

[42] H. R. 5048 provided that the amendments "shall apply to offenses committed on, before, or after the date of the enactment of this act, except that such amendments shall not apply to any offense (1) for which the period of limitations in effect prior to the enactment of this act expired on or before the date of such enactment, or (2) with respect to which the indictment is found or the information is instituted on or before such date of enactment." Except for par. (1), H. R. 3431 contained substantially the same language.

[43] See *U. S.* v. *Beard*, note (4), supra.

[44] This section provides as follows: For the purpose of determining venue in the case of criminal prosecutions arising under the internal revenue laws (including prosecutions arising under section 287 of title 18 of the United States Code in connection with claims under the internal revenue laws)—

(1) Any tax paid (and any amounts accrued or assessed and paid with respect to a tax as interest, additional amounts, additions to the tax, or penalties) shall be deemed to have been paid, and any return, affidavit, claim, declaration, statement, or other document shall be deemed to have been made, filed, delivered, disclosed, or supplied—

(A) in the judicial district in which the defendant resides if paid, or made, filed, delivered, disclosed, or supplied, through the mails, and if deposited in the mails within such judicial district; or

(B) at the office of the principal internal revenue officer for the internal revenue district if paid, or made, filed, delivered, disclosed, or supplied, in any other manner.

(2) The failure to pay any tax (or any amounts accrued or assessed with respect to a tax as interest, additional amounts, additions to the tax, or penalties) or to make or file any return, declaration, statement, or affidavit, or to deliver or disclose any list or account, or to supply any information, when required by the internal revenue laws, and the concealment of property or the withholding, falsifying, or destruction of records in violation of the internal revenue laws, shall be deemed to have occurred in the judicial district in which the defendant resides.

[45] See Ways and Means Committee Rept. No. 1337, 83d Cong., 2d sess., at p. A434.

[46] Note 4, supra.

the prosecution of offenses, or for the recovery of penalties or forfeitures, hereby repealed shall not be affected thereby, but all suits, proceedings, or prosecutions, whether civil or criminal, for causes arising, or acts done or committed, prior to said repeal, may be commenced and prosecuted within the same time as if this title had not been enacted. *The amendments made by section 6531 hereof shall apply to offenses committed on, before, or after the date of the enactment hereof, except that such amendments shall not apply to any offense (1) for which the period of limitations in effect prior to the enactment of this act expired on or before the date of such enactment, or (2) with respect to which the indictment is found or the information is instituted on or before March 8, 1954."* [New matter in italic.]

The CHAIRMAN. Mr. Davis. Sit down and be comfortable, Mr. Davis, and identify yourself to the reporter.

STATEMENT OF FRANCIS W. DAVIS, CONSULTING ENGINEER

Mr. DAVIS. Mr. Chairman, members of the Finance Committee, my name is Francis W. Davis, of Waltham, Mass. Since 1910 I have been connected with the major automobile companies in an engineering capacity and as consulting engineer.

I have served on the council of the Society of Automotive Engineers, as well as several other committees of the society.

With the chairman's permission, may I submit my statement for the record, and then summarize it very briefly?

The CHAIRMAN. It will be incorporated in the record.

Mr. DAVIS. I am the ghost witness who was referred to by Senator Flanders. I am very glad to be here in the flesh.

I appear today as an individual inventor, not for any group or association, on the subject of section 1235 of H. R. 8300, which deals with capital-gains treatment on the sale of patents. My association with the automobile industry goes back almost 50 years, and, as a matter of fact, 2 other lads and myself, in 1906, climbed to the summit of Pike's Peak on motorcycles, which is quite a long time ago.

The CHAIRMAN. Well, you were a mile nearer to heaven. We don't suggest that you need that little extra mile when the time comes——

Mr. DAVIS. I'll make a game try.

Senator FREAR. He didn't mean to imply the closest you could get to heaven is in Colorado.

Senator FLANDERS. You are a mile nearer to heaven right in Denver.

The CHAIRMAN. Off the record.

(Discussion off the record.)

The CHAIRMAN. On the record.

Go ahead, Mr. Davis.

Mr. DAVIS. Section 1235 of the bill gives the inventor less favorable tax treatment than he now receives under existing law.

Under numerous and uniform existing court decisions an inventor who is not in the business of inventing and selling patents, and most inventors are able to show they are not engaged in such a precarious livelihood, can sell his patent at capital-gain rates under an arrangement whereby the buyer obtains exclusive right to make, use, and vend the patented article, in return for periodic payments based upon the productivity of the patent. The Treasury does not agree with these court decisions.

The principal fault of section 1235 is its requirement that the inventor must receive all of the proceeds from his patent within 5 years from the date of sale. One difficulty with this 5-year rule is that it

deals with the sale of a patent, whereas the inventor sells an invention. An invention is usually protected by several patents. That being the case, it cannot be said that the purchase price for an invention is due entirely to a particular patent, or that any given percentage of the purchase price is for a particular patent.

Most manufacturers will not buy an invention unless the inventor-seller agreed to transfer all his patents relating to that invention, even though received subsequent to the sale. Thus, section 1235 is utterly unreal in restricting capital-gains treatment to cases where the purchase price for a patent is received within 5 years from the date of sale.

The inventor is selling something that is completely untried and unknown, and which often requires years to produce. Inventions are of necessity sold under contracts whereby the inventor receives his sales price as and when the invention is produced and sold. Thus, as a very practical matter, the inventor cannot require that he be paid for his invention within the first 5 years of its sale. If he did, he would receive very little for his invention.

The CHAIRMAN. Is not the history of inventions that they do not get their money within 5 years?

Mr. DAVIS. That's correct, Mr. Chairman. In my experience and observation, it is usually a considerable period of time after the granting of the patent before any commercial production takes place.

In the development of an invention, there are various stages that must be covered by the inventor, and also by the purchaser of the invention, before it is submitted to the public. There is of necessity the fundamental idea behind the invention. This is followed by the construction of pilot models which undergo research and testing. Usually, this period leads to a series of improvements on the original idea. If at this stage the inventor is able to interest the manufacturer in the invention, a further period of research and testing is undertaken by the purchaser, in order to determine the cost of production, the necessary tooling and plant equipment and many other factors in the analysis of the market condition and acceptance by the public. This period can, and usually does, cover many years before the invention is ready for marketing.

Somewhere during this period, the inventor applies for patents and the range and scope of patents secured will have a great bearing upon the future progress of the invention. After all these hurdles are covered and the device is placed on the market, the public then determines the success or failure.

My experience indicates that when negotiating for the sale of an invention the would-be purchaser scans the field of competing devices and studies the validity of the inventor's patents. Also, the purchaser diligently investigates whether there is any way of avoiding the patent. These are the normal and practical considerations that enter into the negotiations for the sale or license of an invention.

The proposed section 1235, with its unreal 5-year limitation, offers no compulsion to produce the invention in this period, but to the contrary, would encourage the purchaser to delay development of the invention for this period. This 5 years adds another obstacle in the way of the inventor, and would act to very, very seriously limit the earning power of the invention so far as the inventor is concerned.

Additionally, it will be a strong force to dissuade inventors from marketing their inventions while their applications for patents are pending. Such delays in developing inventions are certainly not in the national interest. The stated policy of the section is to help the national interest, and here it does just the opposite.

It is probably true that 5 years represents the full earning period of the great majority of successful inventions that reach the buying public. But just what period in the life of the patent this occurs is impossible to determine at the outset.

It may be the second 5 years, or the last 5 years, but it is hardly ever the first 5 years after sale. Nobody can select the earning period of a patent within its 17 years' life. The whole 17 years may be zero.

To force the inventor to negotiate the sale or transfer of an invention with the 5-year limitation gives the purchaser an added weapon to beat down the inventor. Not being likely to know the real worth of an invention within the 5-year period, the purchaser will be unwilling and justifiably so, to pay very much for the invention. This is totally unfair to the inventor.

The CHAIRMAN. Isn't it a fact that especially if the invention is somewhat revolutionary it takes a long period of time to condition the mind of the buyers?

Mr. DAVIS. That is absolutely correct. Very occasionally there are some small inventions on patents that are taken out on little ideas and whatnot, that bloom early—and they usually fade early. But if you go into some fundamental development, it takes years and years and years. Sometimes, all too frequently, the idea is ahead of its time and it will not come into use for a long time after the patents lapse. That's correct, Mr. Chairman.

You are probably aware of one of the recent development in the automotive industry called power steering. This consists of using some of the automobile engine power by hydraulic means to assist with steering and also to promote safety of operation.

I am referred to as the "inventor" and "father" of power steering. About 30 years ago, I started investigating this subject. The development such as the kind described is not based upon a single patent, but is an invention based upon a series of patents. There is the basic patent, followed by improvement patents. I secured my basic patent in 1931, and have followed this over the years with a number of improvement patents.

At this time, I would like to call attention to two exhibits that I have here in this field. Senator Flanders will well understand what I am talking about. I have here the valve which is the heart and brain of a hydraulic servo steering mechanism. This valve I hold in my left hand was in the first steering mechanism operated by power that was ever demonstrated publicly to the industry. It is out of the original gear that was demonstrated in Detroit in October 1926, which was only 25 years ago. The valve here in my right hand——

Senator FLANDERS. I think it is more than 25 years ago, and I am sure you would not want a mathematical error to be incorporated into the record.

Mr. DAVIS. That's correct. This original device will show you the complexity of the initial approach to an invention of this kind.

Now, after 15 years of effort, we finally came up with this valve in my left hand which functions exactly like its parent, and does the same

work. It is much lighter, it is smaller, it is cheaper, it is easier to produce, but it is the result of 15 years of study and effort to endeavor to bring it to a commercial standpoint.

This original valve here was mounted and used in 1926 on a Pierce Arrow car. This improved valve is the kind that you are getting today in power steering in such cars as the Cadillac and a number of other makes.

The lapse of 15 years between those two models of the same invention brings to mind a remark made by Charles F. Kettering, the engineering genius of the automobile industry, in which he said "it is a shame that we can't think of the last thing first, because it would save an awful lot of time."

Now, both of those items that I am showing you are the same invention. The first application for patent was filed in 1926. During the 5 years the application was pending, I tried without success to market the invention. My basic patent was issued in 1931. Another 5 years elapsed before I was able to negotiate a sales contract with a manufacturer of automobile parts. It was in 1939 before the first sales were made in the heavy vehicle field. During the year 1939, we sold exactly two units. In the forties we sold a modest number in the heavy vehicle field. Wartime restrictions and Government controls prevented any widespread use until after World War II.

In 1951, one of the major companies finally accepted power steering for passenger cars. Power steering immediately won wide acceptance. Fortunately for me, one of my improvement patents, taken out in 1940, was still alive and has some value. This patent is due to expire in 1957. The picture represents a long struggle and series of patents on one invention and finally a substantial return for a few short years of the life of an improvement patent, barring, of course, unforeseen developments that could easily and quickly remove my invention from the picture. My case is typical of individual inventors, of which only a very few, indeed, reap any final return.

And, once again, I would like to mention another remark made by Mr. Kettering in which he terms that stage that I have just illustrated as the "shirt-losing stage" of an inventor. And well I can believe that.

The inventor after selling his invention, and assuming public acceptance, is up against patent infringement suits, new developments, competing devices, business pressures, wartime restrictions, Government controls, and the like. If an inventor can survive all this, then when the patent expires, he is out of business and finished.

We individual inventors accept our responsibility and are not asking for charity or special consideration. However, we maintain we—when we sell our property—should be placed in no different category from the person who sells a piece of real estate or sells an oil well, so far as tax treatment of the proceeds is concerned.

Section 1235 applies to the sale or exchange of patent rights occurring after the date of enactment of the 1954 code. If the bill, as finally written, grants capital-gains treatment to the transfer of patent rights by assignment of exclusive right to make, use, and vend, even though the proceeds are received over the life of the patent, it should rightfully apply to similar contracts in effect on the date of the enactment of the new code.

My plea this morning is that Congress ought to grant capital-gains treatment to the sales of inventions, to the individual whose efforts created such property. This would be a powerful stimulant to encourage inventors to still greater efforts. And it would stop the litigation. Now the Commissioner forces inventors into court on this matter. The Commissioner always loses. The inventor who has marketed his invention by selling exclusive right to "make, use, and vend" always wins.

In the statement which I have submitted for the record, I have suggested language to rephrase section 1235 to carry out the policy so firmly stated in the Ways and Means Committee report. The present text of section 1235 defeats this policy.

Unless this can be done, then in plain justice to the inventor, I urge you to strike out section 1235 altogether, and let us inventors battle it out in the courts under the present law.

I thank you very much for your consideration.

The CHAIRMAN. Have you talked to the staff about this?

Mr. DAVIS. I have talked to Mr. Stam and members of his staff, and also some of the Treasury staff.

The CHAIRMAN. What was the theory behind this 5-year business? It seems very unrealistic to me.

Mr. STAM. I think what the gentleman said is very true, and we are looking into that. But, you say there is a 5-year period when you get most of your——

Mr. DAVIS. That is the average of earning power of the successful invention, but nobody knows when this period is—whether it's the second 5 years, the last 5 years or when. I have already shown in my case that it is the last 5 years of an improvement patent. My basic patent was issued in 1931—realistically, what I get is the 1952–57 period of a 1940 improvement patent bound by a sales agreement made before it was issued.

The CHAIRMAN. Take a good look at that.

Senator FLANDERS. Mr. Chairman, I might say in looking over this statement, it strikes me that the history of Mr. Davis with his invention is a typical history of the individual inventor. I have known more than one of them. I have known many of them. And, not many of them come through with that last 5 years, as you are doing. But, the situation is not an unusual one, or a permanent one of Mr. Davis.

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

Mr. DAVIS. Thank you.

(The statement of Mr. Davis follows:)

STATEMENT OF FRANCIS W. DAVIS, CONSULTING ENGINEER, WALTHAM, MASS.

My name is Francis W. Davis. My business address is 124 Lexington Street, Waltham, Mass. Since 1922 I have been an independent consulting engineer in the automotive industry. From 1910 to 1922 I was associated with the Pierce-Arrow Motor Car Co. I am a member of the Society of Automotive Engineers, and for some years have been a member of the overseers committee, Harvard University, to visit the Department of Engineering Sciences.

I am presenting this statement as an individual, and not for any group or association, on the subject of section 1235 of H. R. 8300 which deals with capital-gains treatment on the sale of patents. My capacity today is that of individual inventor.

A quarter of a century ago, I invented and patented a power steering mechanism which only since 1951 has been widely used in automobiles.

I desire to present to this committee my experience as an inventor in connection with this device, and to demonstrate, with all the urgency at my command, that important changes are desirable in section 1235 of the bill now before this committee.

Section 1235 of the bill proposes, under very restricted rules, to allow capital gains treatment on the sale of patents by the original inventor. This would apply whether the inventor is the so-called amatuer or is in the business of inventing and selling patents. Incidentally, from my observations and personal experience, I think most inventors can show that they are not engaged in such a precarious business.

The House Report states that the present income-tax treatment of inventors "tends to discourage scientific work"[1] and that section 1235 is intended "to provide a larger incentive to all inventors to contribute to the welfare of the Nation."[2] In 1950 this committee manifested a similar policy in eliminating a provision of the then revenue bill of 1950 which would have excluded all patents from the definition of capital assets.[3]

Unhappily, and certainly unintentionally, section 1235 of the bill gives the inventor worse tax treatment than he now receives under existing law.

In addition, its effect is to practically destroy his bargaining position where he is negotiating for the sale and exploitation of his invention with a company which has the necessary capital, plant, and distribution facilities.

Under existing law the individual inventor can negotiate a contract transferring all rights to make, use and vend his invention, with price geared to productivity and sales, and receive capital gains treatment. And, as far as existing law is concerned, he has complete bargaining freedom.

This tax treatment is assured by almost all of the court decisions.[4] For the 5-year period, 1946 to 1950, the Commissioner of Internal Revenue agreed with this treatment. Since 1950, the Commission has disagreed[5] but the inventor can always take his tax case to the court and have the Commissioner overruled.

The House committee report states firmly that section 1235 is "the only method under the new code" whereby an inventor can secure capital gains treatment.[6]

The basic restrictions of section 1235 are:

1. That there be a "sale or exchange."
2. That the seller retain no interest whatsoever in the invention.
3. That the purchase price may be related to commercial productivity.
4. That the entire proceeds of sale must be received within 5 years from the date of sale.

As to the first requirement that there be a sale or exchange, section 1235 fails to resolve the current (and basic) dispute between the courts and the Commissioner as to when there is a sale of an invention. Although the House report[7] states the section is intended to stop litigation, the prime source of litigation remains: Whether a contract granting sole rights to make, use and vend is or is not a sale. The courts for many years in many cases have held such a contract to constitute a sale. However, the Commissioner insists on disagreeing with the well-established law of sales adopted by the courts in these decisions.

The litigation will grow more intense because inventors must perforce fight to retain something which the Commissioner (from his persistent litigation policy) will certainly claim secton 1235 intended to take away from them.

The limitation of a 5-year period from date of sale within which the sales price can be related to the yield of commercial productivity of his invention leaves the inventor substantially at the mercy, bargaining-wise, of the company which has the capital, plant and distribution facilities.[8]

He will be told "take what we feel like giving you and secure a 25 percent tax rate—if you don't, you will have little salvage at the present high tax rates." This 5-year period of measuring sales price by productivity of the invention must

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[1] P. 82.
[2] P. A280.
[3] S. Rept. No 2375 (81st Cong., 2d sess.), p. 44
[4] See Annex A hereto.
[5] Mim. 6490, 1950-51 C. B 9 (1950).
[6] P. A280.
[7] Pp. 82. A280
[8] The only exception to the 5-year rule is failure of the buyer to make timely payments. Oddly, although the 5-year rule destroys the inventor's bargaining freedom, the House Report states, p. A280:
"In order *not* to leave the seller at the *mercy of a recalcitrant buyer*, the section provides * * *" that delinquent payments are considered as paid within the 5-year period "* * * for the purpose of categorizing the sale as a capital transaction." [Italic supplied.]

run from the date of sale, and the inventor is helpless if the manufacturer elects to stifle production during this period. Under existing law, the inventor can protect himself by requiring a guaranteed minimum payment for the life of the patent. Section 1235 actually denies to the inventor the right to put such a protection clause in his sales contract. The section even forbids the inventor from retaining any kind of a lien to guarantee performance by the purchaser.

Another fundamental error of the 5-year restriction (pointed out to this committee in the testimony of the American Bar Association) is that the restriction covers the sale of applications for patents as well as the sale of patents.

Patent applications are usually pending for several years before a patent issues—5 years is not an unusual period and in fact, was the period in the case of my original patent on power steering. Obviously, commercial development frequently does not take place before it is known that a patent will actually issue on an application. It is quite usual to enter into a sales contract while the application is pending.

If a restriction requiring all purchase price to be paid within 5 years of date of sale is enacted, obviously the inventor will be placed at a great disadvantage. His bargaining position has not only been greatly reduced by an unrealistic rule, but the whole 5-year period may elapse while his application is pending, a period when usually there can be no commercial development.

It is certainly not in the national interest for tax rule to stifle the development and marketing of inventions.

In the usual case it requires years after the execution of the contract of sale before the invention can be exploited commercially. Neither the inventor nor the manufacturer knows how the invention will sell nor what the future holds. Inventions are of necessity sold under contracts whereby the inventor receives the sales price measured by the productivity of the invention. If the invention is financially successful, the inventor and the manufacturer share in its success. If it is a failure, they share in its failure. The manufacturer does not want to risk a substantial capital payment as purchase price. He wants to pay the purchase price out of his profits or sales proceeds.

Nor is it at all practicable to change section 1235 bu putting in any such concept as the "second 5 years," or the "last 5 years." This is just as unrealistic. If a concept like the "second 5-years" were used, how could it possibly be balanced with the years when the inventor's patent application was pending. The inventor is already trying to sell his invention. He may get a customer then—if he is not barred by artificial prohibitions of the tax law. Perhaps in the early years after his patent issues he finds a customers, or, having found a customer, the customer requires several years to tool up and bring the invention to public attention. It may take 1, 3, 5, 10 or more years to find the customer. A concept like "the last 5 years" is just as unrealistic. An invention may be accepted by the public 5 years after the patent is issued then made obsolete by a better device within a year or so. An example of this is the widely publicized CBS color television technique versus that which is now on the market.

Another fundamental error of the 5-year restriction, is its failure to recognize that an inventor does not sell a patent—he sells an invention.

An invention is usually a basic patent, plus related patents on improvements. The "make, use, and vend" sales contract under which the invention is sold contains an obligation to include under the contract not only the basic patent but all future patents on improvements to the invention. These improvement patents can come into existence years after the basic patent. As they issue they automatically fall within the contract and become "sold" as at the time they are issued. There is no way of fitting the matter of improvement patents into such a rigid 5-year system as that proposed.

Since the inventor has sold an invention and, since this 1 invention is usually a basic patent and succeeding improvement patents. The purchaser obviously insists that they must all be covered by the 1 sales contract. In the typical case the inventor can have no practicable means of allocating his receipts under a contract as between the basic patents and the improvement patents, within the 5-year system.

In brief, any artificial rule based on a period of years is unworkable, and places incalculable handicaps on the inventor and operates directly against the national interest for the creation of inventions and their speedy development.

I would like to illustrate what I have said by very briefly reviewing my own situation as the inventor of the power-steering mechanism.

Nearly 300 patents have been issued on power-steering mechanisms. My basic patent and the several improvement patents obtained by me are virtually the only ones that have received any public acceptance and use.

My first patent application was filed in 1926. My basic patent was issued in 1931, 5 years after the filing of the application. It was followed by 11 improvement patents, 1 as recently as last year. Very fortunately for me, the improvement patented in 1940 was of considerable significance.

From 1926 I worked diligently to interest the motor-car industry in buying my power-steering invention. This work entailed exhaustive research and building and testing pilot models. There were all sorts of doubts about public acceptance, capital requirements, tooling problems, distribution problems, etc. In 1936, after numerous negotiations, I finally entered into a sales contract with one company which had the capital and facilities to exploit power steering. Payments to me were primarily related to so much for each mechanism sold. Up to 1941, when 10 years had run on the basic patent, only 2 mechanisms had been sold. During the 1940's sales were in relatively small numbers for industrial vehicles.

The automobile industry did not accept and use the power-steering mechanism in passenger cars until 1951. By then the basic patent and several improvement patents had expired. In 1951, a large manufacturer introduced power steering on its automobiles, with a mechanism based on expired patents and it gained immediate public acceptance.

My invention is now widely recognized as one of the major automotive improvements. Its principal contributions have been in ease and safety of driving.

Meanwhile, of course, my basic patent had expired and had automatically fallen out of my sales contract. Fortunately, the 1940 patent covered a fairly significant improvement, and this improvement patent was, of course, bound by my sale contract. Another car manufacturer in 1951 began using the power-steering mechanism with the 1940 improvement. Beginning with 1952, I began to derive some appreciable reward from the power-steering mechanism and will continue to do so only for the few years until the 1940 patent expires in 1957—providing there are no unforeseen developments that quickly and easily eliminate my mechanism from the picture.

The chronology in my situation is not exceptional. I began work on this invention in the year 1925, patented it in 1931, and will receive some reasonable reward during the years 1952–57.

Note that during the first 10 years of my basic patent its dollar yield was petty in amount. It took the first 5 years of the patent's life to sell the invention. During the second 5 years the manufacturer could not sell the invention to the automobile industry.

Note that as to the 1940 improvement patent, its first 10 years of life were substantially wasted. As a result of 1951 competition started by a company using the invention covered by the expired 1931 patent, the 1940 patent acquired some market value.

Against this brief picture of my own experiences as an individual inventor, which I am sure is not exceptional, I cannot conceive of how the 5-year system of section 1235 can be of any real benefit to inventors. I do not see how it can possibly achieve the declared policy of providing "a larger incentive to all inventors to contribute to the welfare of the Nation." I can see where it will do just the opposite.

In this connection, I want to emphasize that in allowing the individual inventor capital gains treatment on the sale of his invention, there is no question of a loophole—no question of special privilege. It is merely a matter of giving him equal treatment under the law with other persons selling property.

When the individual inventor patents an invention the patent laws give him a 17-year period for the commercial development of his invention. This is what he sells. When he sells this invention he should be entitled to equal treatment under the law with the person who sells a house or an oil field.

It is not my purpose to ask for any special treatment or special privileges for myself or other inventors similarly circumstanced.

All I basically ask is that the Congress should not place us in a worse tax position than other taxpayers.

I make the following suggestions:

(*a*) If it is to be the legislative policy to encourage inventors in the national interest, then section 1235 should be recast to affirmatively allow the tax treatment of existing law, namely, to accept in the form of legislation, the existing court decisions with which the Commissioner agreed for a period of 5 years.

(*b*) If this is not found to be practicable, then it would appear that section 1235 should be eliminated from the bill and individual inventors left to their present remedy of securing proper tax treatment by going to the courts.

(c) If despite its demonstrated infirmities the policy will be to enact section 1235 into law, then a provision should be added to the bill preserving the existing tax position of inventors—so that they can ignore section 1235 and be treated no worse than they are at present.

Attached hereto as annex B are suggested drafts of statutory language related to the different policy decisions the committee may wish to consider.

ANNEX A

SUMMARY OF COURT DECISIONS—INCOME-TAX TREATMENT: SALE OR EXCHANGE OF PATENTS

Once the courts have determined that a given patent or patents constitute a capital asset, held for more than 6 months, they are uniformly prepared to take the next step and hold that a transfer constitutes a "sale or exchange." [1] Therefore, the taxpayer obtains capital gains treatment on the proceeds of such sales. The judicial decisions hold that on assignment of a patent there is a "sale or exchange" notwithstanding the fact that the sales price takes the form of periodic payments similar to "royalty" payments, and despite the Treasury's announced position that payments related to production, use, or sales of the patented article, or periodic payments coterminous generally with the buyer's use of the patent, are taxable as ordinary income.[2]

There are a great number of such judicial decisions. They represent the considered judgment of the Court of Claims, a majority of the circuit courts of appeal, the Tax Court, and district courts. The following statement of law is derived from them:

An agreement constitutes a "sale or exchange" of a patent or an invention [3] if it either expressly assigns or otherwise transfers title to the patent or invention [4] or grants the exclusive right to make, use and sell the patent or invention.[5] Such an agreement is a "sale or exchange" even though the purchase price takes the form of periodic payments [6] based upon production, use or sales of the patented article;[7] even though the agreement is designated as a "license", employs

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[1] Some of the leading articles dealing with this subject are: Casey, Sale of Patents, Copyrights, and Royalty Interests, proceedings of New York University Seventh Annual Institute on Federal Taxation 383 (1949); Fincke, An Analysis of the Income Aspects of Patents, Copyrights, and Their Analogs, 5 Tax L. Rev. 361 (1950); Greenlee & Kramer, Capital Gains on Sales of Patents, 26 Taxes 779 (1948); Pines, Federal Income Taxation of Intangible Assets, 8 Tax L. Rev. 231 (1953); Riddell, Patent Royalties as Capital Gains Under I. R. C., sec. 117 (a), 50 Mich. L. Rev. 991 (1952); Weingarten, Income Tax Consequences of Various Patent Transactions, J. Patent Office Soc. 703 (1952); Wood-Ward, Sales of Patents and Copyrights, proceedings of New York University Ninth Annual Institute on Federal Taxation 987 (1951).

[2] Mim. 6490, 1950–51 Cum. Bull. 9.

[3] *Thompson* v. *Johnson* (42 A. F. T. R. 1284, Dist, Ct. S. D. N. Y. 1950) (discovery); *Halsey W. Taylor* (16 T. C. 376 (1951) Nonacq. 1951–52 Cum. Bull. 6) (invention); *Wilma M. Imm* (11 T. C. M. 258 (1952)) (invention and patent applications).

[4] *Commissioner* v. *Celanese Corp.* (140 F. 2d 339, D. C. Cir. 1944); *Commissioner* v. *Hopkinson* (126 F. 2d 406, 2d Cir. 1942); *Pike* v. *United States* (101 F. Supp. 100 (D. Conn. 1951)); *Thompson* v. *Johnson* (note 3); *Halsey W. Taylor* (note 3); *Carl G. Dreymann* (11 T. C. 153 (1948) Nonacq. 1950–52 Cum. Bull. 5 9 T. C. M 132 (1950)) (same case, different years); *Kimble Glass Co.* (9 T. C. 183 (1947)); *Philip W. McAbee* (5 T. C. 1130 (1945); *Herbert Allen* (11 T. C. M. 1093 (1952)); *Elrod Slug Casting Machine Co.* (7 T. C. M. 157 (1948)); *Lester P. Barlow* (2 T. C. M. 133 (1943))

[5] See *Waterman* v. *McKenzie* (138 U. S. 252, 255 (1891)). In this decision the Supreme Court made the now classical exposition of the principles by which assignments and licenses are distinguished in the following language:

"The patentee or his assigns may, by instrument in writing, assign, grant, and convey, either (1) the whole patent, comprising the exclusive right to make, use, and vend the invention throughout the United States; or (2) an undivided part or share of that exclusive right; or (3) the exclusive right under the patent within and throughout a specified part of the United States (Rev. Stat sec. 4898). A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, with a right to sue infringers; in the second case, jointly with the assignor; in the first and third cases, in the name of the assignee alone. Any assignment or transfer, short of one of these, is a mere license, giving the licensee no title in the patent, and no right to sue at law in his own name for an infringement."

Savo for the decisions cited in note 4, all of the decisions cited in this memorandum involve instruments employing the make, use, and vend terminology.

[6] *Kavanagh* v. *Evans* (188 F. 2d 234 (6th Cir., 1951)); *Parke, Davis & Co.* (31 B. T. A. 427 (1934)).

[7] All of the decisions cited in this memorandum, with the exception of those cited in note 6, involve such payments.

the term "royalties," or designates the parties as "licensor and licensee"[8]; even though either or both parties have a right to terminate the agreement and thereby revest title to the patent or invention in the seller;[9] even though the right of the buyer to sell or reassign the patent or invention is restricted by the terms of the agreement;[10] and even though there are restrictions upon the buyer's right to sue for infringement.[11] Nor is designation of the transaction as a "sale or exchange" affected by the fact that the transfer is only an undivided interest in the patent;[12] is limited to a given industry;[13] or by the fact that there is a subsequent license back to the seller by the buyer.[14]

The unanimity of these decisions, in the face of repeated Treasury attacks, indicates that they are based upon sound and convincing considerations. In *Kronner* v. *United States*[15] the Court of Claims stated some of these considerations:

"These provisions, as well as the others that appear in the agreement, are ones which have become peculiar to the patent field. In *Crown Die & Tool Co.* v. *Nye Tool & Machine Works* (261 U. S. 24) * * * the court stated:

" 'Patent property is the creature of statute law and its incidents are equally so and depend upon the construction to be given to the statutes creating it and them, * * *. It is not safe, therefore, in dealing with a transfer of rights under the patent law to follow implicity the rules governing a transfer of rights in a chose in action at common law.'

"Recognition of this distinction must be made when construing agreements transferring patent rights. *From the viewpoint of both parties, payment on a royalty basis is the only equitable method by which a fair consideration can be obtained.* Provision for termination is needed on the inventor's side since it would be his only relief if the manufacturer stifled production of his invention. A like provision is required by the manufacturer since the invention may prove to be worthless. Since there is no absolute way of insuring that the device patented is completely original, the possibility of infringement is present and the manufacturer desires protection against it." (Italics supplied.)

In *Lamar* v. *Granger*[16] a district court emphasized these considerations in the following language:

"The fact that the purchase price of the patent was to be paid on a certain percentage of the net sales of the product which was made, used, or sold from the invention, does not prevent the vesting of title to the property in the individual to whom the patentee assigns his rights. *Commissioner of Internal Revenue* v. *Hopkinson* (2 Cir., 126 F. 2d 406).

"The parties are not required to be clairvoyant or prescient and determine beforehand a lump amount; it is a matter of speculation. The patent may be commercially marketable or it may not be and the parties account for this risk by providing for installment payments based on a percentage of sales. Congress has recognized this and provided in section 44 (b) of the Internal Revenue Code (26 U. S. C. sec. 44 (b)), that capital gains may be reported over a period of years. These installments have often been designated as 'royalties,' and the

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[8] *Allen* v. *Werner* (190 F. 2d 840 (5th Cir 1951)) ("licensor-licensee"); *Kavanagh* v. *Evans* (note 6), ("nonexclusive"); *Carruthers* v. *United States* (53–1 C. C. H., U. S. T. C. par. 9316 (D. Ore. 1953)) ("royalties"); *Pike* v. *United States* (note 4) ("This agreement shall be construed as a license of the aforesaid patents and not an assignment thereof * * *"); *Lamar* v. *Granger* (99 F. Supp. 17 (W. D. Pa. 1951)); *Thompson* v. *Johnson* (note 3); *Halsey W. Taylor* (note 3); *Kimble Glass Co.* (note 4); *Edward C. Myers* (6 T. C 258 (1946) Acq. 1946–1 Cum. Bull. 3, Acq. withdrawn and Nonacq. Mim. 6490, 1950–1 Cum. Bull. 9, 7); *Parke, Davis & Co.* (note 6); *General Spring Corp.* (12 T. C. M. 847 (1953)) ("royalties, license," seller deducted depreciation after transfer, seller's tax returns showed as its business "Licensing under royalty contracts," and seller claimed to have expended large sums on further development of patent); *Wilma M. Imm* (note 3) ("royalty"); *Herbert Allen* (note 4) ("royalty"); *Elrod Slug Casting Machine Co.* (note 4) ("royalties").

[9] *Kronner* v. *United States* (110 F. Supp. 730 (Ct. Cls. 1953)); *Allen* v. *Werner* (note 8); *Commissioner* v. *Celanese Corp.* (note 4); *Pike* v *United States* (note 4); *Lamar* v. *Granger* (note 8); *Thompson* v. *Johnson* (note 3); *Carl G. Dreymann* (note 4); *Kimble Glass Co.* (note 4); *Edward C. Myers* (note 8); *Raymond M. Hessert* (6 T. C. M. 1190 (1947)); *Lester P. Barlow* (note 4).

[10] *Allen* v. *Werner* (note 8); *Thompson* v. *Johnson* (note 3); *Carl G. Dreymann* (note 4); *Parke, Davis & Co.* (note 6); *General Spring Corp.* (note 8).

[11] *Thompson* v. *Johnson* (note 3); *Parke, Davis & Co.* (note 6); *General Spring Corp.* (note 8).

[12] *Kavanagh* v. *Evans* (note 6); *Parke, Davis & Co.* (note 6).

[13] *Carruthers* v. *United States* (note 8).

[14] *Lamar* v. *Granger* (note 8).

[15] 110 F. Supp. 730, 734 (1953).

[16] 99 F. Supp. 17, 38 (W. D. Pa., 1951).

amount to be paid has been measured by the annual use of the patent by the purchaser."

Only one decision [17] can be cited as arguable contra to the imposing line of the decisions reviewed above. But, as noted by the Court of Claims in Kronner [15] this case largely turned on Internal Revenue Code, section 211, respecting taxation of nonresident aliens.

ANNEX B

SALE OR EXCHANGE OF PATENTS BY THE INVENTOR

SPECIFIC AMENDMENT PROPOSED

I. Suggested text of an amendment which would effectuate the public policy respecting inventors and the development of inventions, as stated in House committee report:

Rewrite section 1235 to read as follows:

SECTION 1235. SALE OR EXCHANGE OF PATENTS BY THE INVENTOR.

(a) GENERAL.—The transfer of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application, by any person whose efforts created such property, whereby the transferee acquires the exclusive right to make, use, and sell the invention throughout the United States shall be deemed a sale or exchange, whether or not the purchase price is related to productivity, use, or disposition of the property transferred, and whether or not the agreement contains provisions permitting termination by either transferor or transferee, or restricting the right of the buyer to sell or reassign the property, or to sue for infringement of the property.

(b) GAIN.—Gain from any transfer deemed a sale or exchange under subsection (a) shall be deemed gain from the sale or exchange of a capital asset.

(c) LOSS.—In the case of the sale or exchange of property specified in subsection (a), this section shall apply only to gain on such sale in excess of loss recognized in any previous taxable year as a loss from the sale or exchange of other than a capital asset, to the extent that such loss was allowed or allowable for any taxable year as a deduction under section 165 (relating to losses) or under section 172 (relating to net operating loss).

(d) RELATED PERSONS.—Subsection (a) shall not apply to any sale or exchange between related persons as defined in section 267 (b) (except brothers and sisters (whether by the whole or half blood).

(e) EFFECTIVE DATE.—The provisions of this section shall be applicable to taxable years beginning after December 31, 1953 (whether the transfer referred to in subsection (a) was made on, before, or after such date) and applicable to all amounts received or accrued after such date. For taxable years beginning before January 1, 1954, the determination of whether or not gain from a transaction described in subsection (a) is gain from the sale or exchange of a capital asset shall be made as if subsection (a) had not been enacted and without inferences drawn from the fact that the provisions of this section are not expressly made applicable to taxable years beginning before January 1, 1954.

II. If section 1235 is not to be amended so as to correct the inadequacies described in this memorandum, then:

Strike out section 1235 and let subchapter P operate as past law has operated.

The CHAIRMAN. Mr. Geisse, sit down and be comfortable and identify yourself for the reporter.

STATEMENT OF JOHN H. GEISSE, WASHINGTON, D. C.

Mr. GEISSE. My name is John H. Geisse and I reside here in Washington.

First, I would like to thank this committee for granting me the privilege of testifying on section 1235 of the 8300.

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[15] 110 F. Supp. 730, 734 (1953).
[17] *Bloch* v. *U. S.* (200 F. 2d 63 (2d Cir.)).

I have just listened to the previous testimony and thought much of mine would be somewhat similar, but I think my recommendations for changes will go further than his.

My interest in this connection stems from a lifetime of experience in executive engineering positions in which I have had to deal with inventors. I am also an inventor myself and have had approximately 25 patents issued to me. I am therefore quite familiar with the problems of inventors and know from experience the difficulties they encounter in attempting to get their inventions developed.

I would like now to refer to page 82 of the House report on H. R. 8300 wherein it is proclaimed that section 1235 is in the interest of the inventor and will in effect reduce his taxes. It is stated therein that "present treatment" tends to discourage scientific work and implies that section 1235 will encourage it.

If the words "present treatment" refer to the treatment accorded to the inventor by the Internal Revenue Bureau and not the courts then I am in complete agreement that it has been discouraging. However, I respectfully submit that it is just this treatment which section 1235 would now make legal whereas under present law appeal from this treatment can be taken to the courts with some confidence that relief will be granted.

It is stated in this report that an amateur inventor receives ordinary income tax treatment if his sale of a patent results in royalty income. This is only true of the treatment accorded by the Internal Revenue Bureau. The courts have repeatedly ruled that the granting of an exclusive license under a patent for the life of the patent is a sale of a capital asset and that payments therefor in the form of royalties do not make it otherwise.

The courts have specifically ruled that the license must be for the life of the patent in order to get capital gains. In direct contrast and just as specifically the Internal Revenue Bureau has ruled that installment payments will constitute ordinary income if, and I quote:

> The period of the payments is generally the same as the time during which the buyer will use the patent.

Section 1235 appears, therefore, to be an attempt by the Internal Revenue Bureau to get additional taxes from the sale of patents which have hitherto been denied it by the courts. Or it may simply be an attempt to justify the Bureau in the rulings which it has made in the past and which have been reversed by the courts.

In either event it is not, as reported, an increased incentive to scientific work. It is worthy of note here that a similar provision was contained in the Internal Revenue Act of 1950 as passed by the House and was taken out by the Senate, I presume on the recommendations of this committee.

The concession granted to the inventor by section 1235 is no more than a concession that the Internal Revenue Bureau will abide by previous court decisions under limitations of its own choosing. These limitations are such as to completely deprive the inventor of any chance of sharing in the success of his invention.

The life of a patent is 17 years but section 1235 provides that the inventor's return on his invention can be commensurate with its success for only 5 years from the date of his contracting for its development if he is to get capital gains. The entire 5 years may very

well be taken up in the perfection of the invention, in getting it into production, and in getting it on the market. Under this condition it is evident that no royalty payments could become due even though they were provided for in the contract.

It has been my impression from what I have read in the newspapers that it is the avowed policy of this administration to adjust the tax burden to encourage the expansion of business—and particularly small business. I am sure that this committee is fully aware that all business today is either directly or indirectly affected by inventions of the past. One cannot now buy anything which is not the direct result of an invention or the cost of which has not been materially reduced by invention. Furthermore, there is no better or surer way of protecting small business from the competition of large business than through the means of a monopoly granted under our patent laws. It would seem, therefore, that the avowed policy could best be carried out by reducing rather than increasing the tax liabilities incurred in the development by invention of new products or better ways of producing old products.

I am going to depart now from the recommendations that have just preceded mine. I would therefore suggest that section 1235 be amended by striking the words, "By the inventor" from the title and all that part of the section following the words "property transferred" in part (a) (1).

In effect, this simply means that all sales of inventions would then become subject to capital-gains tax.

The section as amended would still meet two of the objectives of the House provision in that it would eliminate distinctions between royalty income and installment sales and between amateur and professional inventors. It would not materially change present law as interpreted by the courts, except in the case of those inventors who may be classed as professionals. In such cases under present law patents held by them may be considered as property held for sale in the normal course of their business and hence excluded from capital assets. It would provide assurances to all others that they will receive capital-gains treatment without expensive litigation.

In support of my recommendation I would like to call to the attention of the committee the known fact that the greatest deterrent to the development of inventions is the difficulty of getting financial support for such development. The histories of all of our great inventors have shown this only too well. Those who have been successful have gained that success not so much through their inventive abilities as through winning long and disheartening battles to get their inventions recognized.

Many not so successful have seen others reap the rewards of their inventive skill. Still others have gone to their graves before the value of their inventions has been realized. Those who have attained initial success have almost invariably gone on to make still more contributions to society, contributions many of which would probably not have been made if the inventor did not then have sufficient funds to carry on his development work.

These histories should teach us that there must be many worthwhile inventions which are never developed because of lack of funds therefor. They should also teach us that we probably have many inventive geniuses whose talents are now being wasted for the same reason.

I submit that the adverse effect of high taxes on the proceeds of inventive work is not so much in the discouragement of inventors as it is in increasing the difficulty of getting their inventions financed.

I think that is a point that you should well recognize, gentlemen.

These taxes are taxes on just those funds which are most likely to be available for further experimentation. I have already mentioned the fact that income received by the inventors themselves tend to go back into further inventions. It must also be recognized that those who have profited from financing inventions are more likely to finance additional inventions than are those who have not had this experience.

Furthermore, an assurance of capital-gains treatment on profits made from financing inventions will certainly entice funds into this field which would not otherwise be available.

I am approaching this from the standpoint of financing these things, as much as from the standpoint of the inventor, himself.

Section 1235 as passed by the House is, I submit, not only unwise but also unjust. It singles out the inventor for special treatment which denies him capital gains except under what amounts to a forced sale in a buyer's market. I say this because most inventors have to make arrangements for financial assistance before the value of their inventions has been demonstrated.

On the other hand, the law is not changed for all others and they can continue to get capital gains under much more favorable conditions for sale, if not from the Internal Revenue Bureau then from the courts. I feel reasonably sure that this committee in view of these facts will agree that this is hardly fair treatment for the inventor.

In conclusion I would like to mention a recent experience of my own which I believe is a good illustration of things that do happen in this field of invention. I invented an improved type of cross-wind landing gear for aircraft and secured a patent thereon. Before any development work had been done on this device I attempted to interest capital in its development but failed.

I then submitted it to the Army as something which might be of interest for their liaison planes. They in turn had to submit it to the Air Force for approval. The experts of the Air Force reported to the Army that the device would be worse than useless and would increase rather than decrease the chances of aircraft damage by ground loops.

Fortunately in this case I had the means to carry on the initial development work myself. It was then demonstrated to the Navy and the Navy had one constructed and tested on one of their training planes. Their report on the performance of the gear was very close to being enthusiastic. The gear is now on the market and we have received very favorable reports from our customers. This case should be particularly interesting to this committee as any development which will make it practicable to build only single or parallel runway airports will save the taxpayers many millions of dollars in airport construction costs.

Senator, I would like to add just one more note to my written presentation: The possibilities of the cross-wind landing gears for airplanes were called to the attention of the industry back in 1934. However, no work was done in this field until Congress, itself, provided CAA with $150,000 for this purpose in about 1945, I believe it was. If the gear had been developed back in 1934, we would have

saved a large percentage of the millions of dollars which have been spent in airport construction.

Thank you.

The CHAIRMAN. Thank you very much.

Mr. NELSON. Sit down and be comfortable, Mr. Nelson, and identify yourself to the reporter.

STATEMENT OF MARTIN M. NELSON, ATTORNEY, CHICAGO, ILL.

Mr. NELSON. Mr. Chairman and members of the Finance Committee, my name is Martin Nelson. I am a Chicago attorney, representing two manufacturers of coin-operated amusement machines. I have a statement to put in the record, and to conserve the committee's time I will merely summarize my views with respect to my statement.

The CHAIRMAN. Your statement will be put in the record.

Mr. NELSON. Thank you.

My clients are manufacturers of coin-operated pinball machines, shuffle games, and all types of games using a coin slot. My clients sell these games to distributors, who in turn sell them to operators. The games are then placed in locations, usually on the premises of small shopkeepers, taverns, and other places of amusement, where retail items are sold. The proceeds of the operation are divided between the proprietor of the establishment and the operator. In some instances prizes are given if the player attains a designated score.

Our problem relates to section 3267 of the present code, corresponding to sections 4461 to 4463 of chapter 36, subchapter B of H. R. 8300.

We respectfully submit that the present interpretation of 3267 by the Treasury Department, by the Bureau of Internal Revenue, is an incorrect interpretation.

In 1941 when 3267 became law, such bill originated in the House, and the bill provided for a $25 tax on all types of coin-operated devices, amusement devices as well as slot machines. When that bill reached the Senate, a substantial change was made in the phraseology. And I would like to read an excerpt from the Senate finance report in 1941. This is Senate Report 673, 77th Congress, 1st session, 1941:

> The House bill places a special tax of $25 per year upon each coin-operated amusement or gaming device maintained for use on any premises.
>
> Your committee divides these devices into two categories. Upon so-called pinball or other amusement devices operated by the insertion of a coin or token, the tax is reduced to $10 per year. Upon so-called slot machines, however, the tax is placed at $200 per year.

After the Senate report went to conference, the $10 tax remained on so-called pinball games, and the tax on slot machines was changed to $50. Subsequently, since 1942, the tax on slot machines has been increased from $50 to $200 and then to $250.

I want to make it clear that the clients I represent do not in any way manufacture any device which could be considered a slot machine. None of our items could fall within the definition of Public Law 906, which becomes important because that is a law which was enacted in 1951, prohibiting the interstate transportation of slot machines. And that law, if the committee please, very carefully drew a distinction again between pinball machines and slot machines.

I may say that there was 1 other amendment to section 3267, 1 amendment as to substance, and that was in 1942. That amendment

brought in other additional games, but the legislative intent, as expressed in that amendment, was just as clear, if not more clear, than the Senate report, if that could be possible. It stated:

Under this amendment there will be included, in addition to pinball machines, a great variety of other machines, such as baseball and football games, machine-gun games, music machines (so-called jukeboxes), and many other types of coin-operated games.

Now, these are all games such as have been manufactured and are currently being manufactured by my client. We have a very difficult position, because the taxes placed upon the location owner—that is, the small-shop keeper or tavern keeper. In many States, if the tavern keeper or the shopkeeper would be compelled to buy the $250 tax, which he sometimes is compelled to do by reason of a separate assessment, he would not be able to operate under the laws of a particular State, because in such States there is a prohibition against maintaining an establishment where a gaming stamp is used.

We have had litigation in a number of districts. The problem is presently pending in the courts in Nashville, Tenn.; it is pending in the courts in New Orleans. We estimate that it would be 2 or 3 years before such litigation would be concluded.

It seems to me that the legislative intent could not be more clear, that it was the intent of the Senate in 1941, it was the intent under the 1942 amendment, that a clear distinction be drawn between pinball games and slot machines. And I would like to, if I may, refer to Public Law 906, which deals with the prohibiting of the transportation of gambling devices in interstate and foreign commerce, which became a law January 2, 1951.

When that matter was pending before the committee—and I am now quoting on page 7 of the House report:

In view of the testimony, and because of its intention to exclude pinball machines and similar amusement machines, as well as certain machines and devices commonly used, for instance, at carnivals and livestock shows, your committee decided to adopt a definition of "gambling device" from the one contained in the Senate bill.

Again, the legislative intent is clear. I may say that from 1941, the date of enactment of the bill, until sometime in 1952, the Bureau of Internal Revenue and the Treasury Department took the position that pinball games, irrespective of whether a prize might be given, because of the end use, depending upon the particular locality, would be taxed at the rate of $10.

I have the special tax return which was used until 1952, being form 11B of the Treasury Department, which states:

Coin-operated amusement devices (any pinball game or similar amusement machine), $10 each. Coin-operated gaming devices, slot machines, and other machines involving an element of chance, $100 each—

which was the rate at that time.

This transition, the change in administrative interpretation, has taken place in approximately the last 18 or 19 months. We have no explanation for it. We say that if it continues that some 300,000 people who are dependent upon coin-operated devices, small-shop keepers and tavern keepers throughout the country, as well as the manufacturers and distributors, will be seriously affected. Many of them will have to go out of business.

The CHAIRMAN. What is the reason for that change, Mr. Stam?

Mr. STAM. That was administrative action of the Bureau of Internal Revenue. I think they merely construed these to be gaming devices, and because they said they were gaming devices, they then applied this $250 tax.

Mr. NELSON. On that point I submit for the record five separate rulings from the Treasury Department, covering the period from the late 1940's up until 1951. Not all of these rulings are from the Treasury Department. One is from the collector of internal revenue in Indianapolis, Ind. But each of those rulings, in response to inquiries from operators, distributors, and manufacturers, as the case may be, set forth that the tax was $10 if it was a coin-operated pinball game, a coin-operated bowling game or shuffle game, in one instance, a game now known as ski ball.

We respectfully submit that those interpretations which follow an even course of conduct for a period of in excess of 10 years were the correct interpretations, and that the interpretations of the last 18 or 19 months are incorrect.

I have suggested a proposed amendment to subchapter B, dealing with the occupational tax, and that amendment accepts the first part of the definition dealing with coin-operated amusement or gaming devices, suggesting a slight change. And then with reference to slot machines, I repeat the same definition which was used in Public Law 960. That is the definition which Senator Johnson was primarily responsible for, and I respectfully request that the committee give that suggested amendment consideration. Thank you.

The CHAIRMAN. We will give it consideration. Thank you.

(The Treasury rulings and the prepared statement of Mr. Nelson follow:)

EXCISE TAXES ON COIN-OPERATED AMUSEMENT DEVICES, INTERNAL REVENUE CODE, SECTION 3267 CORRESPONDING TO SECTIONS 4461–4463 OF CHAPTER 36, SUBCHAPTER B OF H. R. 8300—STATEMENT OF MARTIN M. NELSON, ATTORNEY, MADE ON BEHALF OF BALLY MANUFACTURING CO. AND UNITED MANUFACTURING CO., OF CHICAGO, ILL., JOINED BY BAILEY WALSH, WASHINGTON COUNSEL FOR BOTH COMPANIES

My name is Martin M. Nelson. I appear here on behalf of Bally Manufacturing Co., 2640 West Belmont Avenue, and United Manufacturing Co., 3401 North California Avenue, both of Chicago, Ill. Attorney Bailey Walsh, Washington counsel for both companies, has collaborated in the preparation of, and joins me in, this presentation.

The petitioners are manufacturers of coin-operated pinball and other amusement devices.[1] The petitioners sell these devices to distributors who, in turn, sell them to operators. The games are then placed on premises of small-shop keepers, taverns, and places of amusement. The proceeds of operation are divided between the proprietor of the establishment and the operator. The occupants of some of the premises award prizes if the player attains a designated score on each play of the machine or the highest score over a specified period, or, in some instances, they may redeem unused free games for 5 cents each.

THE TAX IN QUESTION

We address our remarks to section 3267 of the Internal Revenue Code, corresponding to sections 4461–4463 of chapter 36, subchapter B of H. R. 8300.

Observing the instructions of your committee, we shall not repeat, except by way of reference, any of the material presented to the House Ways and Means Committee on H. R. 8300.

This matter does not involve a plea for the reduction in taxes. In that we are unique. We simply ask Congress to set aright what, we respectfully submit, is an arbitrary interpretation promulgated by the Treasury Department in applying section 3267.

[1] Neither of the petitioners manufactures what are commonly known as "slot machines."

Section 3267 of the code imposes a tax on "coin-operated amusement and gaming devices." The occupant of the premises where a machine is located is liable for the tax. Under the statutory scheme, "amusement and music machines" and "so-called slot machines" are separately classified and taxed. If the machine is an amusement machine, the tax is $10 per year on each machine. If the device is a slot machine, the tax is $250 per year on each machine. Pinball and other amusement machines should fall within the $10 classification.

However, in the past 2 years an attempt has been made in some districts to include pinabll and other amusement machines under the $250 tax because a prize may possibly be awarded for skillful play. We respectfully submit that the presence of a prize element does not warrant the imposition of the higher tax.

As a matter of fact, since the first enactment of section 3267 and until approximately 19 months ago, the district directors' offices throughout the country have uniformly assessed a $10 tax against pinball and other amusement machines. For some reason the Treasury has reversed its position.

This, we submit, is clearly contrary to law. In support of our position, we respectfully refer this committee to the printed proceedings before the Committee on Ways and Means of the House of Representatives, part 4, topic 40, commencing at page 2505 to 2522, inclusive, whereat there appears a complete statement of our position. By this reference, it is requested that that statement be deemed a part of this presentation.

Therein, we presented a complete analysis of the legislative history of section 3267. From an examination of the House and Senate reports, it clearly appears that the $250 tax was directed only to so-called slot machines. It is especially noted that at the hearing before the House Committee, on August 5, 1953, Congressman Herman P. Eberharter said, "What we intended was to tax one-armed bandits $250." (P. 2517 of House proceedings.) Congressman Eberharter was a Member of Congress when section 3267 was first made a part of the Code, and has been in the Congress continuously to this date. We emphasize that the prior report of the Senate Finance Committee unequivocally emphasized the basic intention to distinguish pinball machines from slot machines (S. Rept. No. 673, 77th Cong., 1st sess. p. 21 (1941).) In the word of the report:

"The House bill places a special tax of $25 per year upon each coin-operated amusement or gaming device maintained for use on any premises.

Your committee divides these devices into two categories. Upon so-called pinball or other amusement devices operated by the insertion of a coin or token, the tax is reduced to $10 per year. Upon so-called slot machines, however, the tax is placed at $200 per year." [1]

The conference report was in accord in its understanding of the Senate amendment. The report stated that "the amendment establishes two different rates of tax: $10 per annum in the case of a pinball game, or similar game or amusement machine, and $50 with respect to so-called slot machines, the operation of which involves an element of chance." [2] The House accepted the Senate amendment and section 3267 was enacted as part of the Revenue Act of 1941.

THREAT TO LITTLE BUSINESSMEN

As a result of the arbitrary position taken by the Treasury Department, hundreds of coin-operated amusement devices—not slot machines—have been seized, bank accounts distrained, and criminal prosecutions threatened. Keep in mind that such drastic procedure is being undertaken in a situation where there is, to say the least, a strong presumption that the $250 tax applies only to slot machines and nothing more. These coin-operated amusement games are for the most part located and operated in small business establishments, usually single proprietorships, operated by individuals and their families, throughout the country. The income from these amusement machines helps them pay their rent. The operation of these machines is not the subject matter of any so-called criminal syndicate. Again, we are not talking about slot machines.

In some States the mere payment of a $250 tax subjects the operator of the game to prosecution under the gambling laws of such State, and even more importantly, results in the revocation of business licenses for taverns and similar places of business representing legitimate and acceptable operations.

[1] See also the additional statement on p. 55 of S. Rept. No. 673.
[2] H. Rept. No. 1203, 77th Cong., 1st sess. 18 (1941).

REDUCTION IN FEDERAL TAX REVENUES

We are well aware of the desire of our Federal Government to give some relief from the heavy burdens of taxation and that the Congress is deeply concerned with this problem. It is, therefore, important for this committee to know that the imposition of the higher tax because prizes are awarded would and is seriously diminishing Federal revenues.

Of special significance is the fact that in the past year the Federal Government yield on Federal taxes on coin-operated amusement and gaming devices has steadily declined. It was reported in the press on November 7, 1953, that the Federal tax on coin-operated amusement games yielded $1,700,000 in revenue in August, 1953, compared to $2,398,000 the previous August. The tax yield since the fiscal year started, July 1, 1953, has reached a total of $4,323,000, down $687,000 from the same period the previous fiscal year. The Federal tax on coin-operated gaming devices yielded $3,346,000 in August, compared to $3,643,000 the previous August. The collections from this tax for the fiscal year to November, 1953, reached $6,948,000, down $655,000 from the previous fiscal year. On January 9, 1954, it was reported that the Federal tax on coin-operated amusement devices yielded $4,737,000 in the first 4 months of the 1954 fiscal year, which began July 1, a decline of $80,000 from the same period the previous year, as reported by the Internal Revenue Service. It is believed that current figures will disclose that declining trend. Needless to say, the $250 tax will drive most of the devices off the market.

ASSESSMENT OF LARGER TAX INVADES THE RAPIDLY DIMINISHING SOURCES OF REVENUE FOR LOCAL GOVERNMENTS

We know that one of the concerns of this Congress, and more particularly, the President of the United States, is the serious financial problems confronting cities, towns, and State governments throughout the country. With the increasing costs of local government, States and subdivisions thereof have been in serious and dire need of increased revenue. Taxes on real estate have about reached the maximum. More and more local governmental bodies have had to look to other sources of revenue, such as sales tax, license fees, and licensing for revenue. Hundreds of cities throughout the United States have already licensed, or are presently considering the licensing of, amusement devices. We presented to the House committee a partial list of the cities and States now licensing coin-operated amusement games. More and more States are utilizing this source of revenue.

It is only fair and equitable that this source of tax revenue be reserved for local governments who do not have the broad, and practically unlimited, taxing powers of the Federal Government. As late as August 1953 President Eisenhower pledged that the administration would cooperate fully in a long-range program to restore to the States many of the powers, responsibilities, and taxing powers they have surrendered to the Federal Government in recent years. This a good place to start.

Further in this connection, as late as March 1954, the Illinois State Chamber of Commerce, in its brochure urging more adequate sources of taxation for State and local governments, said: "The Federal Government should discontinue its death and gift taxes, unemployment tax, the gasoline tax, the tax on lubricating oils, excise taxes on public utility services, admissions and amusement taxes, the tax on coin-operated amusement devices, and the tax on leases of safe deposit boxes." The report noted that this recommendation was made to make more adequate revenue sources available to State and local governments, and for mitigating the present serious overlapping and duplication among Federal, State, and local taxes. The report emphasized that these taxes are more properly of a State and local nature and are capable of adequate administration at those levels.

It is noted, too, that this recommendation has heretofore been concurred in by the Hoover Commission task force in 1948 and by the National Association of Manufacturers in 1952. While we are not urging an exclusion of amusement games from Federal taxation, we do respectfully request an interpretation that will leave this source of revenue to the local governments.

This may not be the most important matter before you, but it affects an industry that could be destroyed unless legislative relief is obtained without undue delay.

CONCLUSION

We are well aware of the important and vital matters that are presented for consideration of this committee, but this problem cannot and should not be excluded.

It affects literally some 300,000 Americans involved in the manufacture, sale, distribution, and operation of amusement games, including thousands of small-store owners who depend on this business for their livelihood. These people are threatened with the extinguishment of this source of income unless immediate clarification is forthcoming.

The affected taxpayers have no adequate remedy at law. The tax is imposed upon the owner of an establishment in which the amusement machine is operated. It is obvious that these small-store owners cannot afford the costly litigation involved in paying the tax, filing a claim for refund and resorting to the courts in extended litigation for a recovery of the tax or adjudicating the liability for the tax. Moreover, as heretofore noted, the mere payment of the tax subjects many of them to the revocation of otherwise legitimate business licenses. It is therefore imperative that this committee act promptly. For the convenience of the committee, we suggest the following amendment to section 3267 which, if adopted, would solve the present urgent problem:

SUGGESTED AMENDMENT

"SECTION 3267. TAX ON COIN-OPERATED AMUSEMENT AND GAMING DEVICES.

"(a) RATE.—Every person who maintains for use or permits the use of, on any place or premises occupied by him, a coin-operated amusement or gaming device shall pay a special tax as follows:

"(1) $10 per year in the case of a device defined in clause (1) of subsection (b);

"(2) $250 per year in the case of a device defined in clause (2) of subsection (b; and

"(3) $10 or $250, as the case may be, for each additional device so maintained or the use of which is so permitted. If one such device is replaced by another, such other device shall not be considered an additional device.

"(b) DEFINITION.—As used in this part, the term 'coin-operated amusement and gaming devices' means (1) any music machine operated by means of the insertion of a coin, token, or similar object; or a vending machine operated by means of the 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, and if the only prize dispensed is merchandise and not cash or tokens; or any amusement machine, including any so-called pinball machine, operated by means of the insertion of a coin, token, or similar object, but not including any device defined in clause (2) of this subsection; and (2) any so-called slot machine or any other machine or device an essential part of which is a drum or reel with insignia thereon and (a) which when operated may deliver as the result of the application of an element of chance, any money or property, or (b) by the operation of which a person may become entitled to receive, as the result of the application of an element of chance, any money or property; or any machine or mechanical device designed and manufactured to operate by means of insertion of a coin, token, or similar object and designed and manufactured so that when operated it may deliver as the result of the application of an element of chance, any money or property."

The definition of machines in clause (2) is identical with the definition of "gambling device" as used in Public Law 906 enacted into law by the Congress, approved January 2, 1951.

TREASURY DEPARTMENT,
Washington, June 6, 1950.

MR. DAVID KAUFMAN,
Kaydeross Park,
Saratoga Springs, N. Y.

DEAR MR. KAUFMAN: Further reference is made to your letter dated May 15, 1950, in which you request to be advised whether the special tax imposed by section 3267 of the Internal Revenue Code with respect to the maintenance for use of the coin-operated device known as X-ray poker ball would be affected in any way if coupons and prizes were issued to the players.

Offering coupons for scores attained on X-ray poker ball machines and redeeming such coupons in prizes, irrespective of the value of the prizes, is considered

not to change the classification of the machine as a coin-operated amusement device.

Bureau letter dated October 30, 1942, which was transmitted with your communication, is returned herewith.

Very truly yours,

CHARLES J. VALAER,
Deputy Commissioner.

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
New Orleans, La., March 23, 1950.

NEW ORLEANS NOVELTY CO.,
New Orleans, La.

GENTLEMEN: Reference is made to your personal call at this office on March 14, 1950, concerning the question of liability for the special tax imposed under section 3267 of the Internal Revenue Code on the bally shuffle bowler machine described in the illustrated circular you submitted.

As advised, your inquiry had been submitted to the Commissioner of Internal Revenue, Washington, D. C., for the issuance of a ruling on the question, and you are informed that we are now in receipt of a response from the Bureau, as per copy of letter dated March 20, 1950, herewith attached. It is held in the enclosure that the machine in question is considered to be a coin-operated amusement device within the meaning of the applicable section of the Internal Revenue Code, and is hereby subject to the special stamp tax at the rate of $10 per year.

Sincerely,

C. A. DONNELLY, *Collector.*
By GEORGE F. BARTLEY, Jr.,
Assistant Chief, Wage and Excise Tax Division.

TREASURY DEPARTMENT,
Washington, March 20, 1950.

COLLECTOR OF INTERNAL REVENUE,
New Orleans, La.,

(Attention: WET: HEH: CFBJr: OR–O.)

Reference is made to your letter of March 14, 1950, wherein you advised that the New Orleans Novelty Co., 115 Magazine Street, New Orleans, has made inquiry concerning the applicability of the special tax imposed by section 3267 of the Internal Revenue Code with respect to the maintenance for use of the bally shuffle bowler machine as described and illustrated in the circular you enclosed.

The machine operates by the insertion of a coin which resets the bowling pins and releases the puck or disk for play.

If the machine is considered to be a coin-operated amusement device, you inquire whether the awarding of a weekly prize for which score by the taxpayer would have the effect of placing same within the category of a gaming device and therefore subject to the $100 tax stamp.

The classification of a machine as a coin-operated amusement or gaming device is not determined solely by the giving of prizes. If the successful operation of a coin-operated device depends on the application of the element of chance, the machine is considered a gaming device. With respect to the device bally shuffle bowler the score is determined by the skill of the player in pushing the pucks over the playing surface of the device and is thus similar to skee-ball and pokerino devices where the insertion of a coin merely releases the balls for play. The play of the game from this point is in control of the player who rolls the balls by hand.

The coin-operated bally shuffle bowler is thus distinguished from those coin-operated devices the successful operation of which is determined by the application of the element of chance, such as slot machines, dice, or free games redeemed. These types of devices are either operated by pulling a lever setting reels into motion, activity of dice, or, in the case of pinball machines, propelling a ball over a playing surface by means of successful scores or free games redeemed. These types of devices are either operated by pulling a lever setting reels into motion, activity of dice, or, in the case of pinball machines, propelling a ball over a playing surface by means of a plunger and may be distinguished from manual

operation, such as in the device described. The mere awarding of a weekly prize for high score on a pinball machine would not bring it within the classification of a coin-operated gaming device.

For the purpose of the special tax the coin-operated bally shuffle bowler is considered to be a coin-operated amusement device within the meaning of section 3267 of the code, even when prizes are offered for its successful operation.

CHARLES J. VALAER,
Deputy Commissioner.

TREASURY DEPARTMENT,
Washington.

Mr. ROY J. BARNETT,
208 South La Salle Street,
Chicago, Ill.

DEAR MR. BENNETT: Receipt is acknowledged of your letter dated March 27, 1951, enclosing letter of same date from the Exhibit Supply Co., Chicago, Ill., concerning the special tax imposed by section 3267 of the Internal Revenue Code and its application to a certain type game which it manufactures. Pictures and instructions concerning the game were enclosed with the letter.

The device is a coin-operated electric shooting target called gun patrol. To increase player appeal the device has incorporated an automatic ticket unit which vends a ticket indicating skill at certain fixed scoring points. The tickets are used in some areas to draw for a weekly or monthly prize.

Advice is requested as to whether the gun patrol should be classified as an amusement or gaming device within the meaning of section 3267 of the code.

The coin-operated device gun patrol, regardless of whether prizes are offered for scoring hits, is considered to be a coin-operated amusement device since the successful operation is attained by the player's skill, as distinguished from the element of chance predominant in slot machines or other similar gaming devices. Accordingly, persons maintaining for use such devices on premises occupied by them incur special tax liability of $10 per year per machine.

Very truly yours,

CHARLES J. VALAER,
Deputy Commissioner.

OFFICE OF THE COLLECTOR OF INTERNAL REVENUE,
Indianapolis, Ind., August 17, 1951.

Mr. EDWIN BLUMENFELD,
314 Willard Avenue,
Michigan City, Ind.

DEAR MR. BLUMENFELD: Reference is made to your letter of August 15, 1951, stating that you are operating a machine referred to as one ball. It does not have a slot paying money in case of a winning score. The player can refuse the free game or games and take cash. The cash is given by the operators of the establishment where the machine is placed. This is the arrangement made between yourself and the proprietor of the establishment. There is nothing on the machine explaining this or anything else concerning a prize.

You are advised that in this connection the Commissioner of Internal Revenue has held that the machine must deliver to the person playing, cash, tokens, premiums, or merchandise, or the machine must indicate to the person playing or operating the machine that he is entitled to receive cash, premiums, merchandise, or tokens. In other words, the machine must have a legend inscribed thereon notifying the player what he is to receive. Private arrangements between the player and the proprietor would not bring the machine within the classification of a gaming device.

From the information submitted, these machines would only be subject to the coin-operated amusement device special tax.

You state further that you own the machine and, in effect, merely rent space in the establishment where you place the machine. You would like to be advised as to whether or not it would be possible for you to take the Federal special tax stamp out in your own name using the address of the establishment where it is placed.

The regulations relating to this tax specifically provide that every person who maintains for use or permits the use of a coin-operated amusement or gaming device or any place or premises occupied by him is liable to the special tax. An operator of such place or premise is considered for the purposes of the law

to become engaged in trade or business is a respect of each such device as of the date the device is placed on his premises for use thereon.

In view of this ruling the special tax stamp must be issued in the name of the person and address on whose premises the machine is located.

Very truly yours,

RALPH W. CRIPE, *Collector.*

NOTE.—Original of this letter on file in office of: James A. Burns, 108 West Michigan Street, accountant for Edwin Blumenfeld.

Re Skee ball alleys and other games of skill.

UNITED STATES TREASURY DEPARTMENT,
Washington, D. C.

NATIONAL ASSOCIATION OF AMUSEMENT PARKS, POOL, AND BEACHES.

GENTLEMEN: Reference is made to your request for a ruling dated September 18, 1952, whether the device known as skee ball alley should be classified as a coin-operated amusement or gaming device within the meaning of section 3267 of the Internal Revenue Code.

You protest a ruling issued by the Director of Internal Revenue, Parkersburg, W. Va., classifying the machine in question as a "game of chance." This is the first instance to your knowledge that skee ball has been considered as such, even though merchandise is given, depending on the score rolled. You state that he demands that an operator of this type of machine in his district must purchase a special tax stamp of $250, while all other operators throughout the United States have only been required to purchase a special tax stamp of $10.

In view of the many types of devices in operation for which prizes are normally awarded for successful operation or high score attained, the Bureau holds that the classification of a machine as a coin-operated amusement or gaming device is not determined solely by the giving of prizes.

If the successful operation of a coin-operated device depends on the application of the element of chance, the machine is considered a gaming device. Generally on this type of device the player after inserting the coin in the machine has no further control over the final result, which is attained by the element of chance, such as pulling a lever, setting reels into action, activity of dice, or, in the case of pinball machines, propelling a ball over the playing surface by means of a plunger.

However, those devices where the insertion of a coin merely releases the machine for play and the high score or successful operation depends on the player's skill, as distinguished from the element of chance, are regarded as amusement devices. The play of the game after the insertion of a coin is controlled by the skill of the player either in throwing or rolling balls, pucks, or disks (manual operation, or shooting a gun at a target, such as skee ball, pokerino, X-ray poker, target games, and also the many variations of skee ball bowling machines now currently in use). These types of devices are thus distinguished from those machines where the element of chance controls and the fact that prizes might be offered for successful operation would not alter their classification as coin-operated amusement devices.

You are advised that the Bureau has consistently held that the coin-operated device known as Skee Ball Alley, regardless of the fact that prizes are awarded for certain designated scores, is considered to be an amusement device within the meaning of section 3267 of the code since the successful operation is attained by the player's skill as distinguished from the element of chance predominant in slot machines or other similar gaming devices.

Accordingly, persons maintaining for use such devices on premises occupied by them would incur liability for the special tax of $10 per year for each machine in operation.

Very truly yours,

H. T. SUARTZ,
Head, Technical Ruling Division.

The CHAIRMAN. Mr. Dewey.

STATEMENT OF WALTER E. DEWEY, BOSTON, MASS.

Mr. DEWEY. Mr. Chairman, you have been listening for a long time. I am going to try to make my remarks as brief as possible.

The CHAIRMAN. Good for you.

Mr. DEWEY. I recently mailed to each member of your committee two statements, covering my proposal to round off the dollar on all Federal income-tax returns. I hope you have seen it, and you have had a chance to examine it to some extent, because I thought it would not only give you advance information, but save time at this hearing.

On three different occasions when I have been in Washington, I have discussed this matter with both Mr. Stam and Dr. Atkinson, and on each occasion, I have felt sure that I had their unqualified approval and support. There is now pending before our State legislature a bill signed by me, authorizing all the accounting departments in the State to round off the dollar in every instance and every case where it could be applied. So the round-dollar idea is growing rapidly.

It has been interesting to me in all these years that I have been studying and working on this project, to find the enthusiasm with which the public has received the idea, people in all walks of life, bankers, professional men, all thought the idea was perfectly sound and hoped it would become a reality.

As an example, one of our leading attorneys in Boston, a member of one of our largest law firms, said to me recently, "Think what that would mean to this office. We make out literally hundreds of tax returns every year of all kinds. Think of the saving of time and labor it would mean to this office if we could eliminate pennies in the preparation of these returns."

And I have made so many tests through the years that I am perfectly satisfied that the pennies can be eliminated on the Federal tax returns without affecting the revenue of the Government, and at the same time, a tremendous saving in time and labor to some 52 million taxpayers.

Now, the benefits accruing will be largely on the part of the taxpayer. He is the fellow——

The CHAIRMAN. Section 7504 relates to fractional parts of the dollar. I quote:

> This section permits the Secretary to round to the nearest dollar any assessment of the deficiency or underpayment and simply to round to the nearest dollar any amount he allows the creditor for a refund.

How does that differ from yours?

Mr. DEWEY. It is a little more elaborate.

The CHAIRMAN. Is there any difference in theory?

Mr. DEWEY. No, not a bit. It is a question of eliminating a penny wherever it is possible.

The CHAIRMAN. What is your point? You have what you want.

Mr. DEWEY. If that is reality, that is all I can hope for.

The CHAIRMAN. I can't guarantee what will be done here, but no one is opposing you.

Mr. DEWEY. I just wanted to get these points over clearly, anyway.

And finally, the public mind now is thoroughly aware of the word "billion" and the national debt because of war and appropriations, and

yet, up to now, when the taxpayer sits down to make out his tax return, he has to deal with the mechanics of adding, multiplying, and subtracting pennies.

Now, it seems too obvious for further comment.

Well, this hearing I regard as the culmination of the 12 years of earnest and sincere work and thought on this subject, and it would be a matter of personal gratification to me to see it become a reality, as well as the millions of taxpayers who will benefit.

The CHAIRMAN. Thank you very much.

We will recess until 10 o'clock tomorrow morning.

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

HOPKINS, SUTTER, HALLS, DEWOLFE & OWEN,
Washington, D. C., April 22, 1954.

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

DEAR SIR: The pending tax-revision bill, H. R. 8300, contains an ameliorative change in section 543 (a) (6) relating to the definition of personal holding-company income. Since the proposed change may affect a problem now pending in our office, we wish to submit comments and suggestions for its clarification, and request that this statement be made part of the record before the committee.

Section 543 (a) (6) of the new bill includes, in the category of personal holding-company income, compensation for the use of corporate property by a stockholder of the putative personal holding company. For convenience, such compensation is herein referred to as "shareholder rent."

Section 543 (a) (7) of the new bill deals with ordinary rents as a component of personal holding-company income. It excludes from the category of ordinary rent, shareholder rent, which is personal holding-company income under section 543 (a) (6). It provides that if rents, as defined, exceed 50 percent of gross income, they are not deemed personal holding-company income. This 50-percent provision originated with section 353 (g) of the Revenue Act of 1937, and was then described as intended to "protect the bona fide real-estate corporation and other corporations renting property and deriving 50 percent or more of their gross income from rents." (Report of Ways and Means Committee; 75th Cong., 1st sess., H. Rept. No. 1546, p. 6.)

So far as concerns these 2 paragraphs, (6) and (7) of section 543 (a), the new bill makes only 1 change from the corresponding provisions of the existing code. It adds, in paragraph (6), a new sentence:

"This paragraph shall apply only to a corporation which has personal holding company income for the taxable year, computed without regard to this paragraph, in excess of 10 percent of its gross income."

The Ways and Means Committee report on the new bill says that the change is intended to relieve cases of hardship where the shareholder rent provision is applied to legitimate business enterprises. The report goes on to say:

"Your committee has provided that such rental income is not to be treated as personal holding company income unless the corporation has other personal holding company income amounting to 10 percent or more of its total gross income. In the absence of appreciable amounts of other investment income, rental income received from shareholders does not constitute a tax avoidance problem." (83d Cong., 2d sess., H. Rept. No. 1337, p. 56.)

The statement in the report is similar in tone and intent to the 1937 report above quoted with respect to ordinary rent.

Accordingly, the statutory scheme is that if ordinary rents comprise 50 percent or more of the gross income they are not personal holding company income. And if shareholder rents constitute 90 percent or more of the gross they are not personal holding company income. The theory appears to be that rents, in many situations, do not lend themselves to the tax avoidance arrangements which gave rise to the personal holding company provisions. Where rents make up stated shares of the gross income, personal holding company liability is not imposed.

Although there appears to be no question about the statutory purpose, it is not altogether clear whether the language achieves that intent. The difficulty arises from the interrelationship between paragraphs (6) and (7), with their respective

and divergent percentage limitations; and from the fact that (7) in terms excludes what falls within (6). Specifically, when personal holding company income is "computed without regard to this paragraph"—i. e., paragraph (6)—is there also to be disregarded paragraph (7)'s exclusion of what falls within (6)? Do shareholder rents revert to the status of ordinary rents and fall within (7) for purposes of computing the portion of personal holding company income which is "in excess of 10 percent" of the gross income?

This question is important because of the 50-percent limitation in paragraph (7). For example, take the situation where all the income is from rents; shareholder rents are 55 percent of the income and ordinary rents are 45 percent. If the new sentence in paragraph (6) means that shareholder rents are not a separate class for purposes of measuring whether other personal holding company income is in excess of 10 percent, then there is no personal holding company income; in the example, rents as defined by paragraph (7) would exceed 50 percent. But, if that is not the meaning, then ordinary rents are less than 50 percent and thus are personal holding company income; they are more than 10 percent, and so the shareholder rents are personal holding company income. The latter result can hardly have been intended.

It is believed that the new sentence in paragraph (6) contemplates relief in the case where substantially all the income is from shareholder rent and ordinary rent, as well as where substantially all the income is from either kind alone. That this is so appears abundantly when we examine possible examples:

(1) Ordinary rent is 50 percent and shareholder rent is 50 percent; not a personal holding company, because under existing law when rent is 50 percent it is not personal holding company income.

(2) Ordinary rent is 10 percent and shareholder rent is 90 percent; not a personal holding company under the proposed new provision, because the income exclusive of the paragraph (6) category is not in excess of 10 percent.

In this class of cases where all (or substantially all) the income is from rents, it would hardly be a logical rule to impose personal holding company liability where shareholder rent is any percentage less than 90 percent and greater than 50 percent of the gross, and not impose that liability where shareholder rent is 90 percent or more or is 50 percent or less. So long as substantially all the gross income is from rents of one kind or another, there is no special evil in shareholder rents comprising 51 percent to 89 percent of the income.

A case in our office presents just this problem, with collateral ramifications not pertinent here. A partnership, members of which are stockholders of a corporation, will have the use of approximately half of the space in a building to be erected by the corporation; "outsiders" will occupy the balance of the space. The distribution of the space is so close that, to be on the safe side, we must assume that the partnership space will account for more than half of the rentals—say 55 percent of the gross income. The problem has been submitted to the Internal Revenue Service on a request for a ruling whether, under the particular circumstances of the case, the rent paid for the assumed 55 percent would be personal holding company income. Revenue has just ruled that it will be, so the clients will either have to abondon the present program or look for relief in the new language in section 543 (a) (6).

If the partnership (stockholders in the building corporation) should pay rentals constituting 90 percent of the corporation's gross, the new language would clearly exclude personal holding company liability. If they should pay rentals constituting 49 percent of the corporation's gross, with the balance of the rent coming from outsiders, then rentals falling within paragraph (7) would be 50 percent or more of the gross and there would not be personal holding company liability. But the stockholders want to occupy space which will account for some 55 percent of the gross, whereupon ordinary rents will comprise only 45 percent of the corporation's income. The view has been expressed at Revenue that the new provision would not relieve the situation from personal holding company liability; that ordinary rents are less than 50 percent and thus are personal holding company income, and that for purposes of new paragraph (6) personal holding company income is in excess of 10 percent of gross.

To make sure that the new language in section 543 (a) (6) gives the relief for which it is designed, it is submitted that there should be some clarification. The situation which we have described is perhaps rare, but can hardly be altogether unique. Where percentages lying on both sides of our percentage

result in exclusion of personal holding-company liability, it is believed that our situation merits the same relief that the others have.

What is needed is a specific direction that shareholder rent be grouped with ordinary rent for purposes of the test, "in excess of 10 percent of its gross income."

A simple solution might be to add, in the new sentence in paragraph (6), a cross-reference to paragraph (7), so that the new sentence would read:

"This paragraph shall apply only to a corporation which has personal holding-company income for the taxable year, computed without regard to this paragraph *and without regard to paragraph* (7), in excess of 10 percent of its gross income." [New matter italicized.]

This would let shareholder rent fall back into the category of general rent for the purpose of examining whether investment income is in excess of 10 percent of gross.

There might also be added to paragraph (7):

"*Provided*, That if the sum of the amount of rents plus the amount described in paragraph (6) is 90 percent or more of the gross income, such amounts shall not be personal holding-company income."

or

"*Provided*, That if the sum of amounts described in paragraphs (1), (2), (3), (4), (5), and (8) of section 543 (a) is less than 10 percent of gross income, no amounts described in paragraphs (6) and (7) shall be personal holding-company income."

The situation would be further clarified if there were included in an accompanying report some such statements as:

"Where at least 90 percent of the income is from rents from shareholders and/or rents under paragraph (7), it is not personal holding-company income.

"In the ordinary case, subsection 543 (a) (7) excludes from rents, as defined therein, rental income from shareholders which constitutes personal holding-company income. The new sentence in paragraph (6) lets shareholder rents be treated like ordinary rents in cases where the total of both such rents is 90 percent or more of gross income."

As we have indicated, the particular case in which we are interested is still in the prospective stage, so this is not a case of seeking a change that may afford retroactive relief. Nor do we believe it to be a matter of asking that the proposed revision be enlarged or extended. If, as appears to us, the new sentence in section 543 (a) (6) was intended to afford relief in a situation such as we have described, we submit that the language should be clarified so to insure achievement of the objective.

Respectfully,

SAMUEL H. HORNE.

A COUNTER TAX—ECONOMIC PROPOSAL BY J. H. LANDMAN, ESQ.

(Mr. J. Henry Landman, Ph. D., J. S. D., is a New York tax lawyer, and is a professor of tax law at the New York Law School)

The pending Internal Revenue Code of 1954, which already passed the House of Representatives and is now before the Senate, and will later be before President Dwight D. Eisenhower for their respective considerations, deserves the praise of all citizens for its high-minded purpose and public spirit in which it was conceived. The 300,000 man-hours of labor which it entails have definitely been fruitful. Its 875 pages represent a conscientious and comprehensive effort to remove many of the inequities and loopholes in our national tax structure. It also purports to effect an upturn from our national economic recession. It is in this latter respect that it is particularly inadequate. Unless the pending tax bill stimulates national economic life, it is bound to be a failure taxwise because of the absence of sufficient national income.

Its primary function is not to raise Government revenue or to alter tax rates. Its contemplated tax changes will, however, result in a revenue loss of $1.4 billion for the fiscal year 1955, but this loss will be offset by the $1.2 billion of revenue to be derived by continuing the corporate tax rate of 52 percent for another year instead of allowing it to drop back to its earlier 47 percent rate.

It is also significant that this bill intends to reduce the annual tax burden of the individual by $778 million in the process of eliminating the comparative injustices of our current tax laws. The tax savings for individuals include more favorable treatment for dependents, medical expenses, child care, heads of families, retirement income, and annuities. Besides, the Excise Tax Act of 1954 which went into effect on April 1 added $1 billion of personal tax savings on excise tax reductions. Then the additional approximate 10 percent tax rate cut for individuals dating back to January 1 help to total $4 billion in tax savings to individuals which will be presumably available for consumption expenditures.

On April 1, the Excise Tax Act of 1954 went into effect reducing the Federal revenue by about $1 billion as determined by last year's national budgetary figures.

It cannot seriously be anticipated that the reduction in excise tax rates from 20 to 10 percent on the retail prices of such luxuries as furs, jewelry, and luggage, and to a lesser extent on the manufacturers' prices of such semiluxuries as home appliances, sporting goods, mechanical pencils, cameras, and long-distance telephone messages, will effect a corresponding increase in the sale and purchase of these commodities and services. Because of the nature of these goods and services, and the recession-induced retrenchment of their potential purchasers, the loss of Government revenue might well be in excess of $1 billion. If the reduction of excise taxes was intended to accelerate the national income, then the relative necessities of life such as alcoholic beverages, cigarettes, and gasoline should have been granted excise tax cuts. It would have been more humane and more sound economically. A wider base of our population would have been stimulated to make purchases. It is doubtful whether a reduction of the excise tax on luxuries will augment their sales and purchases, whether or not their aggregate sales price to the consumer is in fact reduced.

One cannot complain about the fundamental attempt on the part of the draftsmen of both the Excise Tax Act and the proposed Internal Revenue Code both of the year 1954 to eliminate discriminatory tax rates, inequities, and loopholes. We are the most honest taxpayers in the world despite occasional tax scandals only too frequently magnified in relative importance by the sensation-seeking press. Our national honesty with respect to taxation is a particular honor to us as a people, when we realize that our system is a self-assessing one. We grumble about our tax burdens, but we do bear them, knowing that we are the highest taxed people on earth. We resent, however, tax discrimination. To the extent that the above tax laws purport to effect tax justice, they deserve our commendation.

But tax laws do more than raise Government revenue; they actually regulate our national economic life. Taxes is the price we pay for our civilization, but they also determine our economic welfare. Whether we eat oleomargarine or butter, equally wholesome products, is decided by the comparative tax rates imposed on them. Import duties were our primary source of national revenue during our early history. They are relatively insignificant today. They are currently so high that they have ceased being a tariff for revenue and have become instead a protective tariff for selected American industries against the invasion of cheap foreign merchandise.

With these preliminary remarks as to the interrelationship between tax rates and the national economy, one hazards the thought that the above two tax laws might not effect the economic upturn from our current recession which their well-meaning draftsmen prophesy. They expect that, among other factors, the alleged more favorable treatment accorded (1) research and development expenditures in technology and science, (2) soil and water conservation expenditures, (3) the declining balance method of writing off an investment in plant and equipment, (4) an established depreciation rate, (5) operating loss carrybacks, and (6) dividends received by individuals, will constitute additional incentives to economic activity which will result in encouraging production and employment and, as a consequence, will swell the Government revenue.

Let us now turn to an analysis of the alleged economic incentives in the proposed Internal Revenue Code of 1954.

Research and experimental costs.—The ravaging exploitation of our natural resources such as coal, iron, and oil have been responsible for much of our national wealth in the past. Now that they are rapidly becoming exhausted, technology is our new frontier. To encourage research and experimentation in technology and science, the new tax bill proposes that these expenditures be treated as deductible expenses. The time was when such expenditures were capitalized and written off over the 17-year lives of the patents that followed,

or written off as a deductible loss in the year the taxpayer abandoned the project as a failure. Naturally, expensing currently such costs provides an economic stimulus to industry. But it has been the policy of the Internal Revenue Service since February 26, 1952 to permit the current expensing of research, experimental and development expenditures (mim. 6030, C. B. 1946–2 p. 45, revoking I. T. 1610, C. B. June 1923, p. 85). Hence the Internal Revenue Code of 1954 offers no new economic incentive in this regard, and, if enacted, would merely endorse what was already true administratively.

Soil and water conservation expenditures.—Soil and water conservation expenditures are offered in the pending Internal Revenue Code of 1954, current deductibility when they are part of the operating costs of a farm. This proposal is not new. The Tax Court has already decided so even where the expenditures were substantial (*Thompson and Folger Co.* (17 T. C. 722)), and the Treasury had already concurred in this view in the year 1946 (mim. 6030, C. B. 1946—2 p. 45, revoking I. T. 1610, C. B. June 1923). Expenditures for the preparation of land for subsequent farming operations are, however, added to its cost as always.

To insure that these deductible expenditures, including that for the prevention of land erosion, are incidental to and are not preparatory for subsequent farm, ranch and orchard operations, they are limited in the tax bill for any 1 year to 25 percent of the gross income derived from farming, with the excess applicable to subsequent years. Naturally, as heretofore, these deductible expenses would not include the cost of machinery and equipment which are subject to depreciation deductions spread over their estimated useful lives.

Declining balance method of taking depreciation.—The pending Internal Revenue Code of 1954 also offers taxpayers the declining balance method of deducting depreciation on new plant and equipment as an economic stimulus to help the national recovery from the recession. Depreciation is a reasonable annual deduction for the consumption of trade or business plant and equipment, including normal obsolescence. An investment in plant and equipment is therefore, actually nothing but a deferred expense. The annual depreciation deductions enable the taxpayer to recover over the estimated life of an asset its original cost, but rarely are these depreciation deductions funded to finance the replacement of the used-up asset.

The usual method of writing off a depreciable asset is the convenient straight-line method which permits an equal number of deductions over its estimated life, although the appraised annual consumption of the asset depending on usage would be more realistic. The Internal Revenue Code of 1954 offers taxpayers the declining balance method at twice the appropriate straight-line rate on new plant and equipment so that they will be able to write off two-thirds of the cost in the first half and 40 percent of the cost in the first quarter of its useful life. It is called the declining balance method because the cost of an asset is constantly reduced by the prior annual depreciation allowances against which the depreciation deduction rate is applied.

This method of taking depreciation offered in the pending tax bill is not a novel idea in accounting or in taxation. It had always been an accepted accounting and tax procedure where a taxpayer had uniformly employed it. It was particularly authorized by the Treasury in the year 1946 in connection with rental housing provided the applicable rate did not exceed 150 percent of the normal straight-line rate and not 200 percent as in the pending tax bill. (Letter ruling, August 30, 1946, reported in full at par. 76,004 P-H Fed. 1947.) The draftsmen of the Internal Revenue Code of 1954 advocate the declining balance method of taking depreciation to assist in the modernization and expansion of the national industrial capacity which in turn would result in economic growth, increased production, and a higher standard of living.

It is doubtful whether the declining balance depreciation program would have this salutary effect upon our national economy. To start with, all taxpayers engaged in services, retailing and wholesaling, where plant and equipment are not essential, would not directly benefit by this policy. By contrast, those engaged in manufacturing would profit thereby, but they would need new capital to enjoy it. The small manufacturers do not have sufficient depreciation or other funded reserves to avail themselves of this benefit. The bigger ones are more apt to have relatively larger reserves because of the recent rapid 5-year depreciation policy permitted them by law to encourage defense operations. Both the small and large manufacturers would have to turn to the banks and the public to finance in major part the acquisition of new plant and equipment. It is questionable whether the bank will entertain such loans because they are interested

in short-term obligations, and whether the investors would wish to purchase bonds and stock for such a purpose.

Taxpayers do not usually fund their annual depreciation deductions. These allowances are invested in inventory, in receivables or other assets, where the yield is greater, or are distributed as dividends. Consequently, when capital replacements have to be made, taxpayers do not have the cash to make such investments particularly since inflation has of late greatly raised commodity prices.

The following table reflects the sources of funds for the acquisition of new plant and equipment in billions of dollars, excluding banks and insurance companies:

Uses	1953	1952	1951	1950	1949	1948
Plant and equipment outlays	24.0	22.5	21.6	17.0	16.4	19.1
INTERNAL SOURCES						
Retained profits and depreciation allowances	10.0	8.8	10.2	13.0	8.0	12.8
Depreciation allowances	12.0	10.3	8.7	7.9	7.2	6.3
Total	22.0	19.1	18.9	20.9	15.2	19.1
EXTERNAL SOURCES						
Change in income tax liability	2 5	−3.1	6.1	7.2	−2.3	.8
Other current liabilities	1.0	1.3	1.0	1.7	.5	.3
Change in bank and mortgage loans	1.0	3.2	5.2	2.4	−2.2	1.9
Net new issues	7.5	8.1	6.3	3.7	4.9	5.9
Total external sources	12.0	9.2	17.6	15.0	.9	8.9
Total sources	34.0	28.3	36.6	35.9	16 0	28.1

Economic Report of the President, January 1954, table G 47.

New corporate offerings of securities hit their peak in 1952. Then they sagged mostly because the manufacturing industry had less need for new money. The major drops were in the fields of new money for plant and equipment, and for refunding. The 1953 total of new corporate offerings according to the Securities and Exchange Commission was $8.9 billion or 7 percent under the 1952 record of $9.6 billion. The greatest decline was in manufacturing to the extent of about 44 percent from 1952. Public utilities, financial, and real estate offerings almost tripled as compared with 1952. New plant and equipment financing declined slightly from 1952's $6.3 billion to $5.8 billion. The 1954 trend seems to be the same.

Total national capital outlays for 1953 was $28.4 billion or 7 percent above that of 1952, according to the March 18, 1954, survey of the Department of commerce and the Securities and Exchange Commission. It estimates, however, that outlays for new plant and equipment in 1954 will drop 4 percent. It will be $27 billion. Manufacturers' 1954 programs call for an outlay of $11.4 billion which is 7 percent below last year. The small- and medium-sized concerns expect relatively larger declines in capital outlays this year than do the larger companies. Only motor vehicle and other equipment groups plan 20-percent increases in capital outlays over 1953. The electrical machinery and petroleum industries expect relatively small increases in capital replacements.

A substantial number of corporate taxpayers have already pledged an expansion program in anticipation of the enactment of the declining balance method of taking depreciation on new plant and equipment. The list is impressive: General Motors, $1 billion in 1954; General Electric, $160 million in 1954 and a like amount in 1955; Standard Oil of Indiana, $500 million in 1954 and 1955; Standard of California, $275 million in 1954; Bell System, $1.4 billion in 1954; and the utilities and steel companies smaller sums in 1954.

How much of this programing for new plant and equipment is prompted by the unduly large recent 5-year life depreciation deductions permitted taxpayers engaged in defense operations is indeterminable, but it is definitely a contributory factor. On the other hand, there is no assurance that the taxpayers which budgeted these expenditures will not reconsider their programs. The national economy may grow worse. The banks and the public may resist the necessary financing. Then too, the heavy long-life plant and equipment of 25 years or more are actually not benefited enough to make the declining-balance method

of taking depreciation more attractive than the conventional straight-line method. This is so even though a taxpayer could deduct in full its remaining unrecovered investment in its old and relatively inefficient and obsolete plant and equipment by merely abandoning them. Yet it is the new long-lived plant and equipment rather than the new short-lived equipment that is more apt to restore the unemployed to the payrolls and stimulate national prosperity.

There are additional considerations with which taxpayers, contemplating the declining-balance method of taking depreciation, must conjure. Are future tax rates going to rise or decline. If they will increase, the declining-balance method will work a hardship when the annual depreciation deductions become small. Interrelated with this problem is the question whether the future has deflation or more inflation in store for us. If more inflation is in prospect, which is not likely, the declining-balance method is indicated because the purchasing power of the dollars recovered are closer in value to those spent on new plant and equipment. Also, since the declining-balance method makes possible larger tax deductions early in the history of new plant and equipment, it would be taxwise to adopt it if more inflation is anticipated. It must not be ignored that businesswise, irrespective of the questions of future tax rates and inflation, it is desirable to recover quickly one's investment in new plant and equipment at a time when they are most efficient, which is an argument in favor of the declining-balance method of taking depreciation.

Let us grant that the declining balance as compared with the straight-line method of taking depreciation would encourage investment in new plant and equipment, would increase available working capital for other business purposes, and would increase production. Would it at this time help our country out of its current economic recession? Undoubtedly, the investments in new plant and equipment would immediately reflect itself in increased employment in the construction and the tool and machine manufacturing industries, which are now suffering from the cutbacks in the defense program since the end of the Korean incident. But this new plant and equipment will be constructed in accordance with the principles of automation. Automation purports to so mechanize the manufacturing process that output is enhanced and labor requirements are simultaneously minimized, both to degrees unheard of in the past. Hence, the number of men put to work to erect new plant and make new equipment will be more than offset by the reduction of those needed to operate these machines. The output of these machines will in turn tend to flood the market with inventory which the ever-growing army of unemployed will find unable to consume. The great virtue of our system of free enterprise lies in the field of production. Automation, its offshoot, will only intensify capitalistic production. The deficiency of our system of economics lies in distribution. The unemployed are poor consumers and have relatively low standars of living. It seems that we cannot mantain our national standard of prosperity, to use a figure of speech, by taking in one another's washing. Our national prosperity in the recent past is regrettably attributable to war and defense production. While displaced labor will ultimately be absorbed by other industries, more and more automation will make it essential under peacetime conditions to raise still higher our standards of living and to increase our foreign trade if we are to resume the national degree of prosperity we enjoyed in the past. Our greatest market is our domestic one. Our national income in 1953 was $307.7 billion; our exports were 5 percent of that or $15.7 billion. In the face of the greater inroads of automation in manufacturing, we must export more and more if we wish to have national prosperity. Increasing our foreign trade may not be simple. We have revived economically since World War II, particularly Japan, West Germany and Allied Austria who are now our keen competitors in the world markets. They use the most efficient machines that now come from our factories with which we have supplied them, and have lower labor costs for what relatively little labor is required.

Hence a wide adoption of the declining-balance method of taking depreciation is bound to aggravate immediately our unemployment problem. While automation is inevitable, it is not wise to precipitate its wide use at a time when we are urgently seeking to induce a rapid recovery from our national recession.

A stable depreciation rate.—The depreciation rate once established is assured stability under the pending Internal Revenue Code of 1954, which removes the involuntary variable depreciation rate which now annoys business operations. It provides that where the taxpayer and the Internal Revenue Service agree in writing on a depreciation rate for a given asset or group of

assets, that rate will continue to apply until significant facts arise to alter it but then only prospectively and the burden of proving the propriety of the change in the rate must be borne by the party that seeks the change. Even then, the Internal Revenue Service may not effectuate a reduction in the depreciation rate if the change is predicated on a proposed useful life that does not exceed by 10 percent the existing one. It would seem therefore that all taxpayers may with impunity increase their existing depreciation rates by 10 percent.

Actually, the problem of the instability of depreciation rates had been solved administratively in the year 1945. Since this date, if a taxpayer had agreed in writing with the Internal Revenue Service upon a proper depreciation rate for a particular asset, it could use this rate without fear of disturbance for at least 5 years. The Treasury would not disturb such rate unless the taxpayer requested it. In practice, such a determination was just as conclusive without as with a 5-year written agreement (Mim. 5881, June 14, 1945; I. T. 3639, 1944 C. B. 123).

Hence, the pending Internal Revenue Code of 1945 offers nothing new in this regard and consequently the proposed stable depreciation rate is a questionable economic incentive to help lift our country out of its current economic recession.

Carrybacks.—The pending Internal Revenue Code of 1945 offers an 8-year instead of the present 7-year span for absorbing an economic operating loss as a stimulus to encourage a business rise out of our current national recession. Under existing law, deficit taxpayers have a 1-year carryback and a 5-year carryforward to spread their operating losses. This tax benefit is not available to those with consistently profitable years. In addition to providing a 2-year instead of a 1-year operating loss carryback, most of the imperfections in the aplication of the carrybacks and carryforwards of the operating losses have been eliminated.

Theoretically this should be helpful to businesses with marked variances in annual income. Practically, no business enterprise can survive a deficit year the operating loss of which could not be absorbed in two or three profitable ones. Besides, it is elementary, whether we deal with individuals or our Nation, that the only way to effect an economic uplift is to make profits and not to encourage losses. Hence again, the pending Internal Revenue Code of 1945 offers an illusory and deceptive economic incentive.

Double tax on dividends.—The pending Internal Revenue Code of 1954 offers another economic inducement to help our recovery from the national recession. It proposes the elimination in part of the so-called double tax on dividend income under the present law. Earnings of a corporation are taxed twice, once as corporate income and again as individual income when paid out as dividends to shareholders, because dividend payments are not deductions to the corporation. It is contended that this situation discourages equity and encourages debt financing, which is particularly discriminatory against small business which must depend on equity capital for its operations.

The pending tax bill offers in 1954 a $50 and thereafter a $100 dividend exclusion for each recipient. In addition thereto, in the first year a 5 percent and thereafter a 10 percent dividend income credit, limited to 2 percent of taxable income in 1954, 7 percent in 1955, and 10 percent in subsequent years, is allowed. At very high income levels, the percentage reduction in tax on dividend income will amount to about 11 percent.

Only 4½ percent of the taxpayers with a $5,000 income or less, about 75 percent of the taxpayers, report dividend income. On the other hand 8 percent of American families own public corporate stock, and 6.1 of 1 percent of American families own 80 percent of all publicly held stock. Clearly then, any mitigation of the double tax on dividend income is preferential class legislation. This class needs no further inducement to invest in American enterprises. There never was and there is not now an investors' strike. There are no large accumulations of idle cash. Our tax structure is not as repressive as we have been led to believe. Despite the fact that high tax rates have significantly reduced the net incomes of the top 5 percent or 6½ million individuals who traditionally provide most of the investment capital, the flow of their individual investments into business enterprises has not been materially affected (Effects of Taxation, Investments by Individuals, by Butters, Thompson, and Bollinger, Boston, Harvard University, 1953).

If it is wrong to tax dividends because they are taxed twice, then logically it would be wrong to tax all earnings, profits, and gains. There is no com-

modity that is not multiple taxed. Eggs are taxed 100 times, a man's suit of clothes 116 times, a woman's hat 150 times, and a loaf of bread 151 times by the date these commodities reach consumers (The Hand in Your Pocket, by Earl Richert, published by the Tax Foundation). If it is singularity of tax that we seek as an ideal, then let us all espouse the theory of the single tax on land income as propounded by the political philosopher Henry George of the 19th century.

It is doubtful whether the partial elimination of the double tax on dividends in itself will encourage greater public investment in equity securities, though the objective may be sound politically, socially, and economically. To achieve this result, let us make securities more secure, as the term implies. Then let us convince the public that they are now more secure than they were in the great depression of 1929. By so doing, we will attract more people to this type of investment. The public does now want favored as over against unfavored types of income.

A TAX PROPOSAL TO INDUCE NATIONAL ECONOMIC RECOVERY AND INCIDENTALLY GREATER GOVERNMENT REVENUE

Insofar as the pending Internal Revenue Code of 1954 is a conscientious effort to correct the injustices and discriminations in the existing tax law, it is a monument of praise for its draftsmen. Regrettably, this tax bill does not command the same respect for its underlying economics. Yet, unless the national economy is at least as high as it was in 1953, all of the estimates as to Government revenue are in error. If the national economy grows worse, then the tax revenue will become respectively less. On the other hand, if the national economy is better, then we can afford to cut tax rates.

Try as much as they might, competent experts cannot reduce further with impunity the Federal military and civil budget. The heavy cost of Government can be defrayed only by additional borrowing and by taxation. Much of the argument advanced against more Federal borrowing is fallacious. The error lies in the pawnbroker approach to maximizing our national borrowing capacity. In the business world we estimate one's maximum credit by appraising one's liquidated tangible asset net worth under distress conditions. The application of such credit-determining principles to a government is most inappropriate because the primary assets of a nation are not tangible and fixed as in the case of an individual or a business, but its intangible going-concern value consisting of such factors as its dynamic industry and the high living standards of its population. Furthermore, why should not future generations pay only in taxes for the civilization we were able to bequeath to them by the sacrifices our generation made in life and money to preserve and to enhance? It is already indicated that we might properly have to increase our national debt to finance Government projects to help recover from our national recession for our welfare and that of our future generations. Since increasing the national debt commensurately diminishes the Nation's going-concern value, new national borrowing should not be unduly encouraged, but the condition of our Nation's balance sheet is far from being alarming. Morality and ethics dictate that our future generations share in the cost of our civilization.

Naturally, the greater our current Government revenue is, the less do we have to borrow. And the greater our national prosperity is, the lower need be our tax rates. It does not follow that the national revenue is in direct proportion to tax rates. When enterprising incentive is dwarfed and consumer purchasing power is curtailed by taxation, the law of diminishing returns sets in for national prosperity and in turn Government revenue. This has already happened currently.

Let us revive our business incentives to make profits and thus stimulate profits for enterprisers and employment for workers. Let us offer all taxpayers, whether they be individuals, partnerships, or corporations in all types of businesses, whether or not they require plant and equipment, a progressive tax rate cut on their current earnings and profits, exclusive of capital gains, in excess of their own moving averages of earnings and profits for the last 4 years.

To illustrate, a single person would be in the 53 percent tax bracket in the year 1953 if his net income less exemptions was $15,000. He would be in the 72 percent tax bracket if he had earned $40,000. To earn this larger sum he would have to run a risk. No matter what the nature of the legitimate venture, society would benefit with him if he were successful. But our tax structure discourages him from undertaking the necessary enterprise. He would retain only about 28 percent of his profits if he were successful. On the other hand, if he failed, the

Government makes no restitution for his loss. In the aggravated situation, there is cold comfort in a deficit that entitles one to an operating loss carry back and carry forward to offset the tax on profits of other years.

Instead of discouraging this enterpriser, let us offer him a progressive tax rate cut on his excess earnings and profits, not capital gains. For example, the excess might be entitled to a 20 percent reduction in tax rate if he actually earned $40,000 as anticipated, a 15 percent reduction in tax rate if he earned only $30,000, and only a 10 percent reduction in tax rate if he earned $25,000. If his new venture was a failure and he earned only $10,000 in 1953, he should be subject to the regular and usual tax rate. His base would be his average 4-year earnings and profits ending the year 1952. No matter what his earnings and profits were in the year 1953, they would constitute the fourth year of his average basis for his taxable earnings and profits for the year 1954, and, in this fashion, his moving 4-year average earnings and profits basis would be computed for subsequent years.

It is not enough to provide an incentive to make profits for the enterpriser. Our best market is our domestic one; 95 percent of our national output is consumed at home. In the absence of a greater foreign market, we must provide greater purchasing power for our domestic consumers. Let us do so.

One obvious method of effecting this result is increasing the exemptions of taxpayers and their dependents. It is estimated that if the present $600 exemption were increased to $700, it would save taxpayers $2.4 billion per year. Families with incomes below $5,000 would save $20 a person. The savings would naturally increase in proportion to the increases in family incomes. It is estimated it would exempt 4 million taxpayers with low incomes from paying any Federal taxes. It is this last fact that should dissuade one from endorsing this procedure. All taxpayers should bear an allocable part of the cost of Government. Such a situation is a wholesome attribute of an ideal body politic. Accordingly, let us reduce tax rates rather than increase exemptions so as to preserve the large number of taxpayers and still give the public more purchasing power.

Hence the economic philosophy underlying the pending Internal Revenue Code of 1954 should provide a median between greater profits for enterprisers and more purchasing power for our domestic consumers. This should redound to the economic well-being of our country and to the enhancement of the Federal revenue.

Statement of Reynolds Metals Co.

Reynolds Metals Co. appreciates this opportunity to present its views to the Committee on Finance concerning H. R. 8300, a bill to revise the internal revenue laws of the United States. With the committee's permission Reynolds Metals Co. files herewith its statement with respect to the following topics:

1. Consolidated returns and intercorporate dividends.
2. The proposed accelerated payment schedule for corporate taxpayers.
3. Depletion and exploration expenditures.

Respectfully submitted.

C. E. Coghill, *Treasurer.*

(1) CONSOLIDATED RETURNS AND INTERCORPORATE DIVIDENDS

H. R. 8300 should be amended in order to eliminate:

(*a*) The penalty of 2 percent of the consolidated taxable income imposed upon an affiliated group for the "privilege" of filing the type of return which reflects the true income of the affiliated group as a business unit (sec. 1514).

(*b*) The present tax on intercorporate dividends (sec. 243).

(*c*) The inequities and complexities of inventory valuations (sec. 1708).

The first two improvements were recommended by President Eisenhower in his budget message to the Congress on January 21, 1954; they were at first approved by the House Ways and Means Committee at the time of its consideration of H. R. 8300; they have been recognized as proper, sound, and equitable for many, many years; they are tax reforms which are long overdue; and they can be accomplished in the new code without any revenue loss in the 1955 fiscal year.

Under the present law and under the provisions of the tax bill presently before this committee, a penalty of 2 percent of the consolidated taxable income is imposed upon an affiliated group if a consolidated return is filed. The 2 percent penalty is highly inequitable since it penalizes an economic unit for reporting its true income.

Consolidated returns were originally introduced as the best method for measurement of the true taxable income of a business unit consisting of two or more corporations under substantially the same ownership. Since such returns are actually beneficial to both the Treasury Department and the taxpayer, it is contrary to logic, and therefore most unfair, for them to be considered in terms of "privilege," for which the affiliated group should pay a penalty. In fact, as the following excerpt from a report of this committee reveals (Senate Finance Committee Rept. 617, 65th Cong., 3d sess., with respect to the Revenue Act of 1918), the original thinking of the Senate Finance Committee was to require, rather than allow, consolidated returns:

"CONSOLIDATED RETURNS

"Provision has been made in section 240 for a consolidated return, in the case of affiliated corporations, for the purposes both of income and profits taxes. A year's trial of the consolidated return under the existing law demonstrated the advisability of conferring upon the Commissioner explicit authority to require such returns.

"So far as its immediate effect is concerned, consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion which can not be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany accounting assigns too much income or invested capital to company A and not enough to company B. This may make the total tax for the corporation too much or too little. If the former, the company hastens to change its accounting method; if the latter, there is every inducement to retain the old accounting procedure, which benefits the affiliated interests, even though such procedure was not originally adopted for the purpose of evading taxation. As a general rule, therefore, improper arrangements which increase the tax will be discontinued while those which reduce the tax will be retained.

"Moreover, a law which contains no requirement for consolidation puts an almost irresistible premium on a segregation or separate incorporation of activities which would normally be carried as branches of one concern. Increasing evidence has come to light demonstrating that the possibilities of evading taxation in these and allied ways are becoming familiar to the taxpayers of the country.

"While *the committee is convinced that the consolidated returns tends to conserve, not to reduce, the revenue*, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because *the principle of taxing as a business unit what in reality is a business unit, is sound and equitable and convenient both to the taxpayer and to the Government*." [Emphasis added.]

Again in 1933, during hearings before the House Ways and Means Committee, on December 15, the Assistant Secretary of the Treasury testified to the public benefits derived from consolidated returns, as follows:

"* * * there are considerable savings to the Treasury, as well as to taxpayers, in the present arrangement. The administration of the law is simpler since it conforms to established business practice. The Treasury need deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes, an undesirable result in itself. The present law permits a return in accord with business practice, and gives the Treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the Department, the law should not be changed in this particular."

Furthermore, during the hearings on the Revenue Act of 1948, the special tax study committee appointed by the House Ways and Means Committee made the following statement:

"We recommend the elimination of the 2-percent differential charged against corporations for the 'privilege' of making a consolidated return. The principle of the consolidated return is now recognized both in accounting and law as essential to a correct statement of accounts, and as contributing both to simplicity of compliance and accuracy of the income return. The taxpayer gains in his management decisions, and the Treasury gains by having before it a statement which accurately reflects the income of the group. The tax laws should, therefore, encourage, not discourage by an additional tax, the use of consolidated accounts and returns."

It is interesting to observe that there was no penalty on the use of a consolidated return when it made its first appearance in 1917 along with the excess-profits tax. Business produce and other practical considerations many times compel the utilization of several corporations instead of a single corporation. No penalty should be applied where formation of separate corporations is dictated by economic factors unaffected by considerations of the liability for Federal income tax. In light of these facts, simple justice now requires the elimination of the 2-percent differential as a reform long overdue.

The American Law Institute, in its income tax project, has undertaken a complete examination of the Fedemar income tax law with the view that "an objective study [of the Internal Revenue Code] would be helpful to a legislative group in considering problems." In its February 1954 draft, the American Law Institute include the first two of the accommodations urged in this statement with respect to affiliated corporate groups.

As a matter of economics, it is generally admitted that it is unsound to tax corporate profits twice—once to the corporation and again to the shareholder on receipt of a dividend. Moreover, in the case of intercorporate dividends, the distribution would be subject to tax at least three times, and possibly more. With the allowance to corporations of a 100-percent dividends-received credit an important step would be taken toward the elimination of such unwise multiple taxation.

The elimination of the 2-percent penalty and the elimination of the tax on intercorporate dividends are reforms which have been unduly postponed although long recognized as proper. Now is the logical time to accomplish such long overdue reforms.

If the pressure for revenue at the present time prevents the immediate elimination of the 2-percent penalty and the tax on intercorporate dividends, it is suggested that both changes be incorporated in the new code with the provision that the effective date of the eliminations be postponed to the first taxable year beginning after the date of enactment of the Internal Revenue Code of 1954.

This would assure the correction of two long-acknowledged but still unremedied defects in our present tax structure.

There would be no revenue loss to the Government in its 1955 fiscal year and yet the improvements recommended by the President would have been made. It would be most unfortunate if such equitable provisions—reforms so long overdue—should be omitted from the current revision of the Internal Revenue Code.

It is also submitted that section 1708 of H. R. 8300 should be amended to provide that, in computing taxable income for the first consolidated return period for an affiliated group, the amount of the opening inventory of each member of the affiliated group shall be the amount of the closing inventory used in computing the taxable income of any taxpayer for the preceding taxable year, and that in computing the taxable income in a separate return for any member of an affiliated group for the first taxable year after it had joined in filing a consolidated return, the amount of its opening inventory shall be the amount of the closing inventory used in computing consolidated taxable income for the last consolidated return period. Such an amendment would provide an equitable method of treating the complex problem of inventory valuation for the first consolidated return period and for the first period thereafter when separate returns are again filed. Furthermore, the amendment would prevent double taxation of unrealized profits and double deductions of unrealized intercompany losses.

(2) THE PROPOSED ACCELERATED PAYMENT SCHEDULE FOR CORPORATE TAXPAYERS

Section 6016 and section 6154, which have the effect of further accelerating corporate income tax payments by 6 months within the next 5 years, should be eliminated from H. R. 8300 for the following reasons:

(*a*) Under these sections each corporation will be required to pay an additional one-half year's tax, spread over a 5-year period, in such a manner that, if the amounts of taxable income and tax rates are stable, the annual tax payments of a calendar-year corporation during the period will be 110 percent of what would otherwise be its regular annual income tax.

Thus, in the year 1955 the corporate taxpayer on a calendar year basis will pay the entire tax due for the year 1954 plus 10 percent of the tax for 1955—a total of 110 percent; in 1956 it will pay 90 percent of the tax due for the year 1955 plus 20 percent of the tax due for 1956—again 110 percent; in 1957 it will pay 80 percent of the tax for 1956 plus 30 percent of the tax for 1957; in 1958

it will pay 70 percent of the 1957 tax plus 40 percent of the tax for 1958; in 1959 it will pay 60 percent of the tax for 1958 plus 50 percent of the tax for 1959; and after 1959 the corporation would pay in each year 50 percent of the previous year's taxes and 50 percent of the current year's taxes. The effect of sections 6016 and 6154, therefore, is to require the corporate taxpayer to pay approximately 110 percent of the regular tax during each of the 5 years 1955 through 1959.

In view of the high rate of corporate taxes still in effect, these additional payments will place a tremendous burden on the corporate taxpayer throughout a critical transitional period.

The inequity of these requirements contrasts with the fact that, when pay-as-you-go was inaugurated in 1943 for individuals, this committee recommended that the "entire 1942 liability should be abated or canceled, except such part of the liability as could be recouped through certain windfall provisions." (S. Rept. No. 221, 78th Cong., 1st sess., with respect to the Current Tax Payment Act of 1943.)

Further, it is pertinent to note that H. R. 8300 recognizes the great difficulties individual taxpayers experience in preparing their declarations and returns and grants them relief by providing less stringent requirements for declarations and an additional month for filing completed returns. In view of the much greater scope and complexity of the transactions of corporate taxpayers, it becomes immediately obvious that the collection and assembling of financial data—particularly by the medium-size corporations—on an interim basis, with anything approaching tolerable accuracy, imposes a burden on such corporations that was recognized to be unreasonable for individuals.

(*b*) These provisions for accelerated payments may very well more than offset the beneficial effects of any future reduction in the corporate rate during this 5-year period of 1955–59, and of other incentive sections of H. R. 8300,

(*c*) In addition to the hardship brought about by the acceleration of tax payments, these sections, which would require the corporation to file an advance declaration of estimated taxes in September of each year, based on estimates of the final income of the corporation for the same year, multiply red tape and increase the complexity of corporate income tax computation by adding to the present almost overwhelming administrative duties of the corporation the necessity of filing quarterly declarations of estimated tax.

Corporate income is subject to a high degree of variation. Under present law, a calendar year corporation need not file its return for the taxable year until March of the following year. The new plan would require a corporation to file its return and pay one-half of its taxes before the tax year is ended. Many corporations are subject to seasonal fluctuations and realize most of their income during the last half of the taxable year. The requirement of estimated returns and advance payments will be especially burdensome to these corporations, since it will require a disbursement of working capital at a time most sorely needed. The income from many corporations is subject to such extreme fluctuations throughout the year that even the most flexible of penalty provisions would frequently penalize honest underestimates.

(*d*) While only one corporate income tax return is now required, the proposed provisions would necessitate, in effect, three returns: The declaration in September, the amendment in December, and the completed return in March.

The benefits which will accrue to the Government as the result of the advance tax payments will not compensate for the disadvantages to corporations. The Government is on a fiscal year ending June 30. With calendar-year corporations, which constitute more than two-thirds of all corporations, the only effect to the Government of this declaration and prepayment system would be to shift tax collections from the second half to the first half of the Government's fiscal year. Therefore, the only actual annual increase in revenue to the Government would come during the first 5 years from the payments of certain fiscal-year corporations and would constitute only a very small portion of the total corporate income tax payments. As to calendar-year corporations, the Government benefits only by shifting more of the income to the first half of the fiscal year. It may be true that this will decrease short-term borrowing of the Government. But, also certainly, it will be accomplished only by an increase in the borrowing of corporations.

The increase in the burdens of corporate taxpayers, when compared to the slight advantages obtained by the Government, results in a disparity which should be cured by the elimination from H. R. 8300 of the provisions for corporate declarations and for the accelerated payment schedule contained in section 6016 and section 6154.

(3) DEPLETION AND EXPLORATION EXPENDITURES

Section 615 of H. R. 8300 should be amended to remove the limitations on the deductibility of exploration expenditures.

Under section 23 (ff) of the present code, expenditures made during the taxable year for ascertaining the existence, location, extent, or quality of mineral deposits may, at the election of the taxpayer, be deducted in an amount up to $75,000. The yearly limitation of $75,000 applies to all such expenditures made by the taxpayer and is not a separate deduction for each mine or mineral deposit. The deduction is limited to any 4 years (not necessarily consecutive), with the added proviso that, if property has been transferred under circumstances by which there is no change in basis, the transferee is limited to the number of years which were still allowable to the transferor. This limitation of only 4 years applies even though the amount of the deduction taken in any one year is far less than the $75,000 annual ceiling.

The $75,000 annual limitation, which is retained in section 615 of H. R. 8300, is arbitrary and unfair. The limitation applies alike to the small-mine owner and the large development company. Section 23 (ff) of the present code was enacted in 1951 to encourage the search for new deposits of ores and other minerals. The need for this search is underscored by the findings of the Materials Policy Committee (Paley report of June 1952). The purpose of the provision was clearly expressed in the following statement taken from Senate Finance Committee Report No. 781, page 63, on the revenue bill of 1951:

"It is generally recognized that the presently available mineral resources of this country are in many respects deficient in view of the ever-increasing demands of our economy, especially in an emergency period such as the present. Not only is this true with many common metals such as copper, zinc, and lead, but it is even more true with respect to many rare metals and nonmetallic minerals. Intensified and expanded efforts to find new deposits of ores and other minerals are highly desirable.

"Under present law, expenditures for ascertaining the location, extent, and quality of mineral deposits cannot be deducted (unless such expenditures produce no useful results, in which case they can be deducted as with any other loss), but must be capitalized. Amounts so capitalized can be recovered for tax purposes only through depletion allowances. Moreover, if the depletion allowance is based upon a percentage of gross income from the property, this deduction is the same whether a large or a small sum was spent for exploration, so that there is no special tax incentive for increased exploration expenditures. * * *"

The section was intended to encourage the search for much needed additions to our raw-material supply, but the effect of the limitation is to restrict achievement of this very purpose. The limitation is unrealistic since it applies to each taxpayer, regardless of the extent of its exploration activities, its size, or the amount of its annual expenditures.

When coupled with the 4-year provision, the limitation tends to encourage separate incorporations so as to multiply benefits. A large integrated corporation interested in maintaining and expanding its mineral reserves is limited to a small fraction of the annual amounts it is required to spend for exploration; and, further, even the limited benefits of the section as it now reads are unavailable to it after the short period of 4 years. On the other hand, if several corporations were organized to explore mining properties, the benefits of the section would be correspondingly multiplied. Thus, there is the possibility of accomplishing indirectly that which cannot be done directly. Not only would this be remedied, but the removal of the limitation would actually accomplish an affirmative objective in the public interest. The most equitable treatment for tax purposes of these expenditures would require the removal of all limitations, except the incentive limitation automatically imposed on the corporation by the desire to maximize profits.

Since the purpose for which the section was added to the present code was to encourage exploration expenditures, the curb on the method used to attain the purpose should be removed. Section 615 of H. R. 8300, which retains the limitations, should be amended by striking out both the 4-year limitation and the $75,000 annual limitation so that all bona fide exploration expenditures incurred in the search for much needed additions to the Nation's ore and mineral supply may, at the election of the taxpayer, either be deferred or deducted as a current expense. The following amendment to section 615 (a) of H. R. 8300 is proposed:

Section 615 of H. R. 8300 should be amended by striking therefrom the first sentence of subsection (a) and adding in lieu thereof the following sentence:

"There shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine or deposit."

Section 615 (c) should be stricken from H. R. 8300 and subsection (d) should be relettered (c).

THE TEXAS CO.,
New York, April 22, 1954.

Hon. EUGENE D. MILLIKEN,
Chairman, Senate Finance Committee, Washington, D. C.

DEAR SENATOR MILLIKEN: Attached hereto is a memorandum entitled "Comments of the Texas Co. Regarding Proposed Provisions of H. R. 8300 as They Affect Employee Benefit Plans."

We understand that the bill is intended to liberalize in various respects the tax treatment afforded employers and employees in connection with employee benefit plans, as well as to simplify and clarify the necessarily complex provisions dealing with this matter.

Nevertheless, as the memorandum points out, there are certain provisions in the bill which would or could result in serious hardships and inequities for both the Texas Co. and its employees with respect to certain of its employee benefit plans.

As many other companies have in effect plans which are similar to those of the Texas Co., they and their employees would likewise be unfavorably affected.

The deleterious consequences of H. R. 8300, pointed out in the memorandum, with respect to employee benefit plans of the types involved, undoubtedly are unintended, and we are confident that the committee will desire to amend the bill so as to avoid the hardships and inequities which would or might otherwise result. Accordingly, the memorandum makes certain suggestions for amendments which seem to us appropriate to accomplish this purpose.

In lieu of asking for time for a representative of our company to testify before the Senate Finance Committee, we are filing our memorandum with you, and request that it be included in the record of the hearings now in progress, and be considered by the committee.

Very sincerely yours,

EDWARD W. FREEMAN,
Associate General Counsel.

COMMENTS OF THE TEXAS CO. REGARDING PROPOSED PROVISIONS OF H. R. 8300 AS THEY AFFECT EMPLOYEE BENEFIT PLANS

These comments relate to the proposed provisions in H. R. 8300 as approved by the House of Representatives, relating to employee benefit plans.

1. EMPLOYEES SAVINGS PLAN

The Texas Co. and various subsidiaries have adopted an employee savings plan for employees effective July 1, 1952. Also, three affiliated pipeline companies, no more than 50 percent of whose stock is owned by the Texas Co., have adopted and participate in the same plan.

Briefly, an eligible employee is given an option to contribute to an employee's trust 2, 3, 4, or 5 percent of his base pay on a pay-class basis. The employer then contributes, out of its accumulated earnings, an amount equal to 50 percent of the amount contributed by the employee. The employee may direct that any or all of the funds in his account be invested by the trustee in one or more of (*a*) certain United States Government bonds, (*b*) capital stock of the Texas Co., or (*c*) the common shares of certain investment companies. If the employee desires not to invest the funds in his account in any of the above, the uninvested funds in the hands of the trustee are held without interest. Purchase of the company stock is made on the open market. Under the plan the employee's account vests at death, retirement, or after 60 months of participation in the plan. Forfeitures derived from unvested accounts are distributed among all remaining accounts on the basis of total contributions in such accounts. The

Internal Revenue Service has ruled that the Texas Co. plan is qualified under section 165 of the Internal Revenue Code.

As of December 31, 1953, 27,811 out of approximately 35,000 employees of the Texas Co. and its subsidiary and affiliated companies were participating in the employees savings plan. Of the total employees eligible to participate in the savings plan, it is estimated that approximately 90 percent have elected to do so. Of the 27,811 employees participating in the plan it is estimated that 84.2 percent had elected to contribute 5 percent of their base pay and the remaining 15.8 percent had elected to contribute 2, 3, or 4 percent.

Section 501 (e) (4) (B) of H. R. 8300 provides that, in the case of profit-sharing plans, at least 75 percent of the employer's contributions each year, and all amounts arising from forfeitures or for any other reason, be allocated in such a manner that the allocated amounts do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower. It further provides that the remaining employer contributions be allocated in such a manner that the total allocation as a percentage of compensation to any covered employee does not exceed twice the minimum allocated to any other covered employee whose compensation is lower.

Under the Taxas Co. employees savings plan, the employer contributes from 1 percent (one-half of 2 percent) to 2½ percent (one-half of 5 percent) depending upon the election made by the employee. It can be seen readily that the contributions of the employer are not uniformly related to the compensation of the participants; furthermore, the contribution for one employee may exceed twice the amount of the comtribution for another by reason of the election made by an employee. It is understood that many savings plans throughout the country, covering vast numbers of employees, contain similar provisions and will be similarly affected.

The drafters of section 501 (e) (4) appear to have had in mind noncontributory plans and the rules set forth might be reasonable for such plans. However, we do not believe that thrift plans, such as the Texas Co. employees savings plan, should be made to conform to rules intended to be applicable to noncontributory plans. Under the proposed statute, the Texas Co. would have to provide only one option, say 5 percent for all employees, and this would force the 15.8 percent of participating employees who have elected to contribute less than 5 percent to contribute 5 percent or drop out of the savings plan.

If the Texas Co. plan were to continue in its present form, and section 501 (e) (4) (B) is enacted into law, the plan would continue to be qualified. However, if any substantive change should thereafter be made in the plan, the Internal Revenue Service would probably require the plan as changed to meet the requirements of H. R. 8300. If such requirements were not met, the plan would be treated as an unqualified plan. If the plan should become unqualified, one of its major purposes would be defeated. Under the plan the earnings realized by the trustee, are not taxed to the trustee, in accordance with section 165 of the Internal Revenue Code. The earnings are taxed to the employees when distribution is made to them pursuant to the plan. However, the earnings of an unqualified trust are subject to tax, and, in the case of the Texas Co.'s employees savings plan, it is estimated that the maximum tax of 87 percent of the earnings might be imposed if the plan should become unqualified.

In addition to the disastrous effect of rendering a trust taxable, the employer and the employees would be adversely affected in other ways. The company would be denied a deduction for its contributions at the time of the contribution, the deductions being postponed to some indefinite future time when the money is paid to the employees or their beneficiaries. The employee would be denied capital-gain treatment and the right to defer the tax on the unrealized appreciation in the employer's securities.

We recommend that H. R. 8300 be amended to recognize contributory savings plans, such as the Texas Co. employees savings plan. We suggest that section 501 (e) (4) (B) be amended to permit the qualification of contributory savings plans which allow the employee to save different stated percentages of his wages and the employer to contribute a stated percentage of the employee's contributions which for this purpose may be determined by reasonable pay rate classifications.

The employees of the three affiliated pipeline companies already mentioned are permitted to participate in the savings plan on a par with other employees except that they are denied the right to defer the tax on the appreciation in employer securities distributed to them because the Texas Co. does not own more than 50 percent of the stock of such companies. However, if section 505 of H. R. 8300 is enacted in its present form, it would appear to cause the auto-

matic disqualification of the plan for these affiliated companies. Section 505 prescribes allowable investments for employee trusts. Securities of the employer or securities of a parent corporation or subsidiary corporation of an employer are permissible investments. Section 505 (b) generally requires ownership of more than 50 percent of the stock of an affiliated corporation in order for the stock of the parent corporation to be a permissible investment. Section 403 (c) (1) provides that existing exempt plans will continue to be exempt "subject, however, to sections 503, 504, and 505." Therefore, this can be interpreted to mean that the savings plan for the pipeline companies would be disqualified effective March 1, 1954.

We also suggest that section 505 (a) be amended to permit investment by a trustee of an employee savings plan in the stock of an affiliated corporation of the employer. It may be desirable to define an affiliated corporation as one owning 10 percent or more of the stock of the employer provided that under the plan the employee has an election to invest in the stock of such corporation.

The bill provides for the continued qualification of existing qualified plans; however, if employee benefit plans are to continue to serve their purpose they must be susceptible to amendment in order to keep pace with our economic and social progress. Because of this, amendments must be contemplated. It is not believed that an already qualified plan should be subjected to all of the new tests simply because the plan is to be amended. Therefore, it is recommended that H. R. 8300 be amended to provide specifically that, for a reasonably limited time, such as 2 years after enactment of the new provisions, such plans will not be subjected on an overall basis to the new tests simply because of an amendment to the plan.

It is submitted that the above recommendations should be adopted to avoid extensive hardships and inequities for both employers and employees.

2. PENSION PLAN

After an employee is with the Texas Co. for 1 year he is eligible to join the pension plan which provides the retired employee a monthly pension for life. The plan provides for retirement of male employees at age 65 and female employees at age 60. The amount of the pension depends upon the length of the employee's service and upon the various pay rates applicable to the employee.

In addition to the benefits available under the plan for current service, the Texas Co. plan provides, entirely at the expense of the company, a pension credit for past service, i. e., service before July 1, 1937. Also, the company provides a pension credit for employees while on military leave of absence granted by the company.

The Texas Co. pays approximately two-thirds the current cost of the pension plan; and the balance is borne by employee contributions.

On July 1, 1953, the Texas Co. and its wholly owned subsidiaries carried 35,462 employees on their payrolls. Of this number, 31,242 were eligible for membership in the plan. Of those eligible, 30,526 were participating in the plan, or 97.7 percent.

H. R. 8300 purports to simplify existing provisions controlling qualified plans. The Texas Co. commends this laudable intent; however, it feels that in developing such intent certain unnecessary restrictions have been imposed which may vitally affect the qualified status of many existing plans covering vast numbers of employees.

Section 501 (e) (4) (A) provides that the "contributions or benefits of or on behalf of" an employee under the plan must "not bear a higher ratio to compensation * * * than for any other covered employee whose compensation is lower," except that the first $4,000 of annual compensation may be disregarded. It is submitted that this requirement will work severe hardship in some cases. For instance, it is common practice for employer-corporations having employees in foreign service to retire such employees at an earlier age than domestic employees. In order to do this, of course, the company contributions and the benefits are greater for foreign service employees than for domestic employees. While it is not absolutely clear that this would disqualify existing plans such as that of the Texas Co., it is feared that the possibility exists.

The proposed provision provides that "the contributions or benefits" must not bear a higher ratio to the compensation of a covered employee than for any other covered employee whose compensation is lower. It is obvious that to fund a unit benefit type pension plan, it is necessary to contribute more in the case of older employees. This factor alone dictates a disproportionate contribution

between employees of different ages in the same pay class. The proposed provision can be interpreted to disqualify a plan because of such contributions. This point could be taken care of easily by inserting the word "either" before "contributions or benefits" in section 501 (e) (4) (A) of the bill.

Also, where participants are divided into pay classes, it is possible to have disproportionate benefits between participants whose salary places them close to the top of one pay class and others whose salary places them at the bottom of the next higher pay class, although if the means of the two pay classes are compared there would be no such disproportion. Thus, the proposed provisions can be interpreted to disqualify existing plans because of such disproportionate benefits. Again, this point could be taken care of easily by the addition of a provision at the end of section 501 (e) (4) (A) that for the purposes of such section compensation, contributions, and benefits may be determined on the basis of reasonable pay rate classifications.

If the proposed provisions are enacted as passed by the House of Representatives, the Internal Revenue Service may be compelled to rule, at the first request for permission to make changes, that many existing pension plans are nonqualified. It is not believed Congress intends such a catastrophic result.

3. ACCIDENT AND SICK BENEFIT PLAN

The Texas Co., like many other employers, provides an accident and sick benefit plan for its employees. The accident and sick benefit plan automatically covers an employee upon completion of 1 year's service with the company. This plan provides benefits to the employee when he is temporarily laid up because of illness, or because of an accident on or off the job. The Texas Co. pays the entire cost of this plan; the employee pays nothing. It is not an insured plan.

The employee absent from his job because of illness or accident receives a benefit under the plan equal to his full base pay for a specified period depending upon the length of his service with the company. If that specified period expires and the employee's absence continues because of the illness or accident, he then receives a benefit under the plan equal to one-half of his base pay for an additional period. The following table shows the periods for which a Texas Co. employee may receive benefits under this plan:

Years of service	Period of full base pay	Additional period of ½ pay
	Weeks	*Weeks*
1	4	2
2	4	7
3	4	12
4	4	17
5	8	18
6	8	23
7	8	28
8	8	33
9	12	34
10 or more	13	39

If a part of these specified benefits are payable as workmen's compensation, or some other amount payable according to law, this plan provides only the balance which when added to that part will equal the specified benefit. In the case of employees paid on an hourly basis, there is a waiting period of 1 working day before the benefits are applicable.

There is considerable confusion and disagreement under existing law with respect to the taxability of employees on benefits received from accident and sick benefit plans. Generally, however, amounts received as accident or sick benefits are exempt only if they are paid under a contract of insurance.

The proposed law sets forth an entirely new set of rules in this area. Employees would not be taxed on employer contributions to an accident or sick benefit plan, whether insured or noninsured. Insurance benefits paid for by employee contributions would continue to be exempt; benefits financed by the employer through insurance or otherwise would be exempt only if paid under a qualified plan. The bill prescribed the tests to be met for qualification: (1) The plan must be for the exclusive benefit of employees; (2) the employee must have an enforceable right to benefits; (3) the plan must be nondiscriminatory as to employee coverage, contributions, and benefits; and (4), if benefits for loss of wages are provided, there must be a waiting period before they begin.

The proposed law would encourage employers to qualify these plans. Employers with existing plans, such as that of the Texas Co., however, might encounter certain serious obstacles in meeting the tests for qualification. For instance, under the Texas Co. plan, benefits are based, in part, on the length of service with the company; this, apparently, would conflict with the prescribed test since it does not meet the classification rule spelled out in section 501 (e) (3) (A) of H. R. 8300. Furthermore, it is doubtful that such existing plans would meet some of the other tests prescribed in section 501 (e) and made applicable to accident and health plans by section 105 (c) (1) (C).

It is understood that there are many accident and health plans where the employer's contributions and the employee's benefits are based in part on the length of the employee's service. Some of these plans have been effective for a long time and cover vast numbers of employees. If Congress intends to provide relief from taxation in respect of accident and health plans, it is recommended that section 105 and related provisions of the bill be amended to recognize and approve these plans, based in part on the length of service with the employer. It is submitted that such plans are based on a reasonable classification.

In order for an accident and health plan providing payment of compensation for loss of wages to be qualified, section 105 (c) (1) (D) requires a waiting period before the time when such payments begin under the plan. Since many accident and health plans of long standing either vary the waiting period according to recognized classifications of employees or do not require a waiting period, it is recommended that, for all purposes, the requirement of a waiting period be eliminated.

In addition to the foregoing, since many of these plans are not funded in advance, it is recommended that section 105 be clarified to remove the implication from the phrase "contributions of the employer" that such advance funding may be required.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: I am writing in confirmation of the verbal statements made by me today in connection with a matter that has just been brought to my attention and concerning which the corporate reorganization provisions of H. R. 8300, specifically section 359, would in their present form have a prohibitive impact.

Two large financial institutions in Maryland, of substantially the same size, have for some months been studying the possibility of a consolidation which, in addition to the usual advantages of such a consolidation, would permit the new institution to provide banking services of a size and scope not now practicable. The proposal involves the exchange of stock now held by the shareholders of the existing banks for stock in the new institution. I am advised that the negotiations have now progressed to the point that concrete plans have been made to submit the proposal to the respective shareholders within the next 60 days, subject, of course, to the requisite approval of the proper public authorities having jurisdiction in these matters.

The approach to this proposal was made, needless to say, in reliance upon the reorganization provisions of the existing Internal Revenue Code, under which the contemplated exchange of stock would not result in taxable capital gain to the stockholders. One of the institutions involved, although it has several hundred stockholders, would come within the definition of a non-publicly held corporation" contained in the present draft of section 359 of H. R. 8300. I am told the impact of these new provisions would be so substantial on many stockholders who have held their stock for many years, that the proposal to consolidate, with all of its advantages, would doubtless be abandoned unless by change in the proposed section or by change in the proposed effective date thereof, the consolidation could be consummated without the subjection of the stockholders to tax on the exchange. It is clear to me that this proposed consolidation does not fall within the category of the remedies sought to be attained by the concept of publicly held corporations.

I wanted to call this important case to the attention of the committee as an example of the deterrent effect of the proposal on constructive mergers and consolidations. I know the committee has had many similar examples before it.

It is submitted that it would be unfair and inequitable to make these changes in the law effective retroactively, if they are to be adopted at all. If the new concept of "publicly held corporation" is to be accepted by the Congress, it is felt that it would be unjust to make that provision applicable to transactions begun and consummated during the year 1954.

Very truly yours,

HERBERT R. O'CONOR,
Attorney at Law.

INVESTMENT BANKERS ASSOCIATION OF AMERICA,
NEW YORK 5, N. Y., *April 22, 1954.*

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington 25, D. C.

DEAR SENATOR MILLIKIN: I am writing you on behalf of the Investment Bankers Association of America in connection with the current hearings before the Senate Finance Committee on H. R. 8300. I would appreciate your making this letter a part of the record of these hearings.

By way of identifying the Investment Bankers Association for the record, it is a voluntary unincorporated trade association of investment bankers and security dealers, the members of which provide investment banking services and underwrite and deal in all types of securities in practically all parts of this country and Canada. We have approximately 800 member firms and these firms, in addition to their main offices, have about 1,100 branch offices throughout this country and Canada.

First, we should like to commend the Congress, the Treasury Department, and their staffs on the tremendous effort which is reflected in H. R. 8300 to bring about a long overdue comprehensive revision of our revenue code. As in any such effort there are bound to be unforeseen and unintended consequences, many of which have been and are being brought to the attention of your committee at its current hearings on H. R. 8300 and, because of the exceedingly short time which has been available for study of the specific provisions of this bill, there may indeed be many unfortunate results not yet foreseen. We hope, however, that after due consideration of such suggestions as are made that this new revenue code will be adopted at least in major part at the current session of the Congress.

With our limited staff and the wide geographical dispersion of the members of our Federal taxation committee and our board of governors, it has not been possible for us in the limited time available to make the sort of comprehensive study of this measure which we would have liked to make in other circumstances, but as the result of such study as we have been able to make we should like to urge your earnest consideration of the following comments on certain provisions of this bill in their present form.

Approve relief from double taxation of corporation dividends; recommend capital gains tax rate and holding period be cut in half

As Mr. G. Keith Funston, president of the New York Stock Exchange, indicated in his statement before your committee on Monday, April 12, 1954, we heartily endorse the comments and recommendations made by him at that time supporting the provisions of the bill which provide limited relief from the existing double taxation of corporation dividends and recommending that both the present capital gains tax rate and holding period be cut in half. Our reasons for this support and for our belief that cutting both the capital gains tax rate and holding period in half would produce immediately increased revenues to the Treasury and have many other highly desirable economic consequences were well stated by the president of our association last year, Mr. Ewing T. Boles, in his statement before the House Ways and Means Committee on July 28, 1953. It is my understanding that the record of those hearings is before your committee and that you do not wish reargument made of any points covered at those hearings.

Recognition of gain or loss to corporations in corporate acquisitions and separations, sections 354 and 359

Under existing law no gain or loss is recognized in statutory mergers or consolidations of corporations if certain general conditions are met—and those conditions do not include a requirement that, if either of the corporations is not

"publicly held," the shareholders of the transferor corporation must obtain a specified percentage of the participating stock of the acquiring corporation.

Under section 354 no gain or loss would be recognized in statutory mergers or consolidations of "publicly held" corporations (as defined in section 359 (a)); but under sections 354 and 359 if either (or both) of the corporations is not publicly held, gain or loss in the merger or consolidation would be recognized unless the shareholders of the acquired corporation own at least 20 percent of the participating stock of the acquiring corporation immediately after the transaction. These provisions are based on the assumptions that publicly held corporations "as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level" while "closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital-gains rates."

Those assumptions may be correct, but they do not alter the fact that many closely held corporations merge or consolidate with other corporations for sound business reasons not connected with tax advantages. The requirement that shareholders of the acquired corporation must own at least 20 percent of the participating stock of the acquiring corporation immediately after the transaction is obviously unfair because the 20 percent figure is an arbitrary one which bears no relation whatever to the business purpose or the tax advantages connected with the transaction.

Publicly held corporations of any size could merge or consolidate without recognition of gain or loss. Two closely held corporations within certain ratios of size could merge or consolidate without recognition of gain or loss. But if a small closely held corporation—for sound business reasons not connected with tax advantages—merged or consolidated with a corporation more than four times its size, the gain or loss would be recognized.

Our concern with these provisions of H. R. 8300 does not stem primarily from their likely impact upon consolidations and mergers of firms in the securities business, but rather from their likely impact upon the business community and our economy, generally. It must be remembered that there are hundreds of thousands of corporations of all sizes which will be affected. Typically in this country, our corporate form of doing business has developed to the state which it enjoys today by the entrepreneur starting out in a small way with a new idea, growing if the idea proved to be a sound one and there was the requisite capital and managerial ability available, merging or consolidating with other and frequently larger corporations for a whole host of sound business reasons, with deferred tax consequences until there occurred a true economic realization. We believe that our tax laws in the past, which have permitted this type of evolutionary business development, definitely have been in the interest of our economy and general well-being and that any arbitrary restrictions, based upon size, will be definitely not in the public interest. They would certainly be discriminatory against small and medium sized closely held corporations, and we think, particularly under modern competitive conditions, that mergers and consolidation of such small closely held corporations should be encouraged, in the public interest, rather than discouraged. If there be tax evasion in this field we feel very strongly that some other and more direct approach should be taken to close any such loopholes.

These provisions, in addition, are made retroactive to March 1, 1954, and this factor has had the effect of bringing to a halt many negotiations for proposed mergers and consolidations which have reflected much time and effort, but which cannot be carried out in a great many cases pending the final determination of the effective date of these and like provisions. We have already had many such instances brought to our attention where the parties must necessarily just mark time until the final content and effective date of these provisions are decided.

We would recommend, therefore, that the law be left substantially as it presently is insofar as corporate consolidations and mergers are concerned where there is a sound business reason therefor, and that in any event any new provisions in this field not be made effective until after December 31, 1954.

Preferred stock bailouts, section 309

The general explanation of section 309 in the House committee report on H. R. 8300 states that its purpose is to eliminate the use of a mechanism commonly known as the "preferred stock bailout" whereby an attempt is made to withdraw earnings from a corporation at rates applicable to capital gains, rather than at rates applicable to dividends, by causing a preferred stock dividend to be declared on holdings of common stock and then selling the divi-

dend stock. To discourage this type of transaction section 309 would impose an 85 percent excise or transfer tax on the corporation on the amount paid by it to redeem the preferred stock. This tax would apply to any redemption within 10 years after the stock was issued (subject to certain specified exceptions) and preferred stock outstanding on January 1, 1954, is to be deemed issued on that date for the purposes of section 309, irrespective of how long before that date it may actually have been issued.

We have no quarrel with the attempt to close this type of loophole, where there is in fact a so-called typical "bailout," but we believe that section 309 as drawn covers many situations not in fact "bailouts" and that it is a wrong approach to the solution of the problem.

In the first place, we have serious doubt that section 309 would accomplish its purpose. A corporation could merely refrain from redeeming the preferred stock for 10 years after its issuance and no tax would be imposed on any redemption after the expiration of the 10-year period. In the meantime, the preferred stock could be disposed of at capital gains tax rates.

As we understand section 309, the 85 percent transfer tax would be imposed irrespective of whether or not a "bailout" had actually occurred. That is to say, for example, if the preferred stock was issued out of paid-in surplus and not out of earnings, the tax would apply to the redemption of such stock.

In our view section 309 is a proposed tax on the wrong person, i. e., on the corporation rather than on the stockholder who, in effect, is getting earnings at capital gains tax rather than dividend tax rates. It is a tax which would be most unfair to minority stockholders and new stockholders. We would recommend, therefore, that the approach to this problem as embodied in section 309 be discarded for one which imposes a tax on the stockholder involved in the "bailout" rather than a tax on the corporation. If the approach embodied in section 309 is retained in the bill despite the difficulties pointed out above, we recommend that the proposed tax apply only if the preferred stock is issued after the date on which the new law is finally approved by Congress.

Amortization of bond premiums, section 171

Under existing law a bond premium may be amortized with reference to the amount payable on maturity or on an earlier call date, at the election of the taxpayer. This means that in the case of bonds with a very short call provision, such as those providing for redemption at any time on notice of 30 days or 60 days, etc., the entire premium may be deducted in the year of purchase.

As pointed out in the House committee report at page 26, this provision has given rise to tax avoidance opportunities, because many bond issues which have been issued subject to a 30-day or a 60-day call permit the purchaser to take an immediate deduction against ordinary income for the entire amount of the premium, and then after 6 months to sell the bonds subject to long-term capital gain treatment. The write-off of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. In order to curb this tax avoidance scheme the bill provides that the premium on callable bonds may be amortized to the nearest call date only if such date is more than 3 years from the date of original issue of such securities. It is further provided that this provision would apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.

A serious objection to this proposal lies in the fact that it would unintentionally but necessarily result in subjecting bonds with short-call features to a substantial tax disadvantage. As pointed out in the recommendations of the Federal Tax forum, this will necessarily result in inducing prospective issuing corporations to insert in their bonds a restriction on redemption within the first 3 years of issue, a restriction which is considered inadvisable by most investment bankers and other financial experts and which in fact is frowned upon as a matter of policy by the Securities and Exchange Commission.

It is recommended that section 171 (b) (1) (B) should be amended so as not to forbid entirely amortization to the nearest call date in the case of bonds callable within 3 years of issue; but (1) to require that, in the case of such bonds, the bond premium be amortized on the assumption that such bonds are in fact callable 3 years after their date of issue; and (2) to provide that where the bonds are in fact called for redemption within such 3-year period, the unamortized balance of premium may be deducted in the year of redemption.

Dividends from fire, casualty, and marine stock companies, sections 34 (c) (1) and 246 (a) (1)

Section 34 provides for a limited credit against tax to individuals on dividends received from corporations. Section 243 provides for a deduction to corporations for dividends received from other corporations. The purpose of these sections obviously is to mitigate the effect of double taxation of corporate profits. Sections 34 (c) and 246 (a) provide certain limitations with respect to the aforementioned credits and deductions. These limitations are designed to eliminate the credit and deduction in situations in which no double taxation in fact occurs.

As sections 34 (c) (1) and 246 (a) (1) are presently drawn, however, they have the effect of denying the credit and deduction to individuals or corporations receiving dividends from stock of fire, casualty and marine stock insurance companies, even though such companies are fully taxed on their income, as are corporations generally.

It seems to us that this discrimination against the stockholders of such fire, casualty and marine stock companies is clearly inequitable and, indeed, we suspect it was inadvertent. If these sections of the code, however, should not be changed to give stockholders in such companies the same treatment as other stockholders, it would drastically affect, adversely, the market for such stocks and it would make it very difficult for such companies to aquire additional capital or to establish new companies of this sort, even though they play a vital role in our economy.

We suggest, therefore, that these sections should be amended to remove this unjust discrimination against the fire, casualty and marine insurance business.

Disallowance of deduction of interest on contingent interest bonds sections 275 and 312

Under present law corporations are permitted to deduct payments for interest on bonds, regardless of whether payment of such interest is unconditional or is contingent upon earnings.

Under sections 275 and 312 of H. R. 8300 corporations would not be allowed to deduct any interest paid on nonparticipating stock which would include bonds on which the payment of interest is contingent upon earnings.

The report of the House Ways and Means Committee on H. R. 8300 states that the purpose of this provision is to permit deduction of interest only on "bona fide debts". However, the effect of the provisions in sections 275 and 312 goes beyond the intended purpose because contingent interest bonds (also known as income bonds) represent "bona fide debts" of the issuing corporation although the payment of interest is contingent upon earnings. Bonds of this type constitute a definite obligation to pay a sum certain in money at a fixed maturity date. If the earnings of the corporation are adequate to pay interest, the interest must be paid; such interest is not payable, as are dividends, only in the discretion of management. In short, contingent interest bonds represent a credit obligation and not an equity interest.

Although there have been instances where there were attempts to camouflage equity interests as debt obligations in order to give the issuing corporation a deduction for interest payments, the courts have invariably looked through such subterfuge to find the real nature of the security. Moreover, we know of no case where such a subterfuge has been attempted with respect to contingent interest bonds issued by railroad corporations, and it is the disastrous effect of sections 275 and 312 on railroad contingent interest bonds which is of concern to us.

The relatively unsatisfactory credit condition of the railroad industry has long been apparent to investors, investment bankers and to Federal authorities. It becomes a matter of great concern that sections 275 and 312 would operate to undermine further the already inferior credit position of the railroads of this country.

A majority of the railroad contingent interest bonds have been issued in connection with reorganizations under section 77 of the Bankruptcy Act and in accordance with plans promulgated by the Interstate Commerce Commission and approved by Federal district courts. These bonds were allocated to former holders of fixed interest bonds in full or part settlement of their defaulted claims. In many instances the same old bondholders also received equity securities to fill out the satisfaction of their defaulted claims. The contingent interest feature was necessary in such bonds because of the sharp fluctuations in earning power experienced by such a cyclical industry. By the use of contingent interest bonds old bondholders could remain as creditors while at the

same time the fixed charges of the reorganized company were held to levels which could be supported even under adverse conditions.

Large amounts of contingent interest bonds have also been issued by railroad corporations in accordance with procedures allowing for voluntary debt adjustment plans. By this method many railroads have been able to escape the costly and time consuming procedures required by the bankruptcy laws and have minimized the possibility of unnecessarily wiping out stockholders. Under sections 275 and 312 it would be most difficult to secure the assent of affected security holders to a plan whereby part of their fixed interest became contingent upon earnings if the result of such a proposal were to shift a part of earnings due bondholders to a tax liability resulting from the denial of a deduction for interest paid on contingent earnings bonds. The alternative to a voluntary debt modification plan probably would be default and bankruptcy. Such a prospect would further impair confidence in the securities of an industry whose earnings are not only inadequate but are also subject to sharp fluctuations.

Consequently, it appears clear that (1) interest paid on contingent interest bonds should be deductible because such bonds represent bona fide debts and (2) denial of a deduction for the interest paid on contingent interest bonds by railroad corporations would seriously undermine the already inferior credit position of railroad corporations.

Accordingly, it is recommended that section 275 be eliminated in its entirety, or that section 312 be so modified as to include contingent interest bonds of railroads within the classification of "securities" and to exclude such bonds from the classification of nonparticipating stock.

Very truly yours,

T. J. BRYCE, *President.*

APRIL 22, 1954.

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

STATEMENT OF NATIONAL LIVESTOCK TAX COMMITTEE ON H. R. 8300

DEAR SENATOR MILLIKIN: In accordance with your invitation, I am very happy to submit this statement on behalf of the National Livestock Tax Committee concerning H. R. 8300, the proposed Revenue Code of 1954. We would be glad to have this statement included in the record of hearings before your committee. As you know, the National Livestock Tax Committee represents the American National Cattlemen's Association, the National Wool Grower's Association, the 4 national cattle breed associations, 22 State cattlemen's associations, 15 State woolgrower's associations, and the American Thoroughbred Breeder's Association. It speaks for the livestock producers generally throughout the United States.

We wish to congratulate the staff of the joint committee and the Treasury on the tremendous work undertaken in redrafting the Internal Revenue Code. This has been, I am sure, an almost super-human effort. We are in general accord with the purposes and accomplishments of the bill. In any draft of such magnitude, however, omissions, ambiguities and errors are sure to occur.

We make no claim to have analyzed every provision in the bill. We have concerned ourselves only with those matters of particular significance to the livestock industry, as contrasted with other taxpayers. We may well have failed to note some points of significance even in this limited field. However, based on our study to date, we wish to make the following suggestions. We feel that these are merely interpretative, matters of clarification, and within the intent of the bill as drafted. Amendments along the lines suggested, however, or additional explanation in your committee report, may avoid the possibility of future misunderstanding or dispute.

Section 119, Meals and lodging

We are in accord with the purpose of section 119, to clarify and liberalize present rules for determining whether board and lodging furnished by an employer to an employee constitute compensation to the employee. We feel however, that the section, as presently worded, is subject to too literal an interpreta-

tion. It excludes the value of meals and lodging from gross income of an employee only if:

1. Such meals or lodging are furnished at the place of employment; and
2. The employee is required to accept such meals or lodging at the place of employment as a condition of his employment.

In the livestock industry, we have the example of the sheepherder who, furnished by his employer with a wagon and supplies, follows his band of sheep for weeks or months and for hundreds of miles through remote and inaccessible country, often several days' journey from any town or habitation. In a practical sense, his meals and lodgings are furnished at his place of employment and are required as a condition of his employment, but a narrow and literal interpretation might cast some doubt. A similar situation exists with respect to the cowboy who must live and take his meals on the ranch because it is too far into town to live and eat there and to do his work. We think that the committee report should include language making it clear that a practical, rather than a literal, intepretation of this section is intended. Perhaps an example of the sheepherder or cowboy would be helpful.

Section 175, Soil and water conservation expenditures

We are in hearty accord with the addition of section 175 permitting an election to deduct soil and water conservation expenditures. It is our understanding that the provision relating to adjustments in basis will be eliminated. Although these adjustments in basis are designed for the benefit of the taxpayer, we feel that they are of such minor importance as a practical matter, and so complicated as a matter of drafting, that they should be eliminated in the interests of simplicity.

Of equal importance, is a suggestion that additional examples of soil conservation practices covered by the option, be included. It might be urged that the examples included in section 175 (c) (1) are those typical of the Midwest, where cultivation is predominant rather than of the Far West where pasturing is more prevalent. One of the most frequent items of soil and water conservation work on the open ranges of the West is the construction of small earthen dams in the dry gulleys for the purpose of catching surface runoff of water. Their purposes are threefold, and all related to conservation:

1. To conserve the scarce and valuable flow of water;
2. To prevent the erosion of soil from the gulley; and
3. To establish frequent waterholes on the range so as to spread the concentration of livestock grazing and prevent their trampling grass and eroding the soil around the few natural waterholes.

We earnestly urge that this type of expenditure be included, as an example. This is particularly important for the reason that the phrase "earthen dams" has been included in a great many bills introduced in Congress on this subject in past years and its omission in the current bill might be misinterpreted as intending an exclusion. We see no danger involved in the fact that earthen dams can be large and expensive. They involve no more expenditure than leveling, contouring or any of the other works listed, and the revenues are protected against abuse, by the 25 percent limitation.

We also suggest that the word "reseeding" be added to the enumeration, as representative of another type of conservation practice. If the inclusion of these words—"earthen dams", "reseeding"—is for any reason undesirable in the bill, then surely their example should be included in the committee report.

Section 446, Accounting methods

The proposed bill is intended to liberalize permissible accounting methods and to recognize commonly accepted business practices. It specifically approves the use of combinations of accounting methods or hybrid methods. In this connection, the House committee report gives an example of a permissible hybrid method in the case of a small retail store.

It would be helpful if the committee report gave another example of a permissible hybrid method. A great many, perhaps most farmers and ranchers who carry their animals in inventory, keep their books and file their returns on the cash basis in most other respects. They deduct interest and taxes, for instance, when paid rather than as accrued, and they keep no inventory of feed or supplies. This is a simple and practical method of accounting. It is a natural way of reporting income where the farmer's records are only a checkbook and a livestock count. It reflects income just as clearly as the pure cash basis. It is used in varying detail by hundreds of thousands of small farmers and ranchers.

A recent Tax Court case, however, *Diamond A. Cattle Company* (21 T. C. No. 1), can be interpreted as disapproving of this hybrid method. If it were upset, a chaotic situation would result. Because of its wide use, therefore, and the doubt cast on it by the Diamond A case, we urge that the Senate committee report refer to it as another example of a permissible hybrid accounting method. The following language might be appropriate:

"Another recognized accounting method, in the case of a rancher or a farmer, will be the inclusion of livestock in inventory and the accrual of purchases and sales of livestock, together with the accounting for some or all of the other items of income or deduction, such as property taxes, interest, feed and supplies, on a cash basis * * *"

Section 1033. Involuntary conversions.

Section 1033 concerning involuntary conversions remains unchanged from section 112 (f) of the present code, with respect to an issue of importance to the livestock industry, namely the application of this section to livestock which die or whose sale is forced because of poisoning, injury, disease or drought. We have previously urged that this section should be amended so as to specify that it applies to the foregoing situation. We have met with some question, however, as to the application of the provision to drought because of the difficulty of differentiating between drought and routine dry weather. We feel that the revenues would be adequately protected by the general requirement that, if contested, the burden of proof is on the taxpayer to demonstrate the existence of the situation justifying relief, and also by the requirement of section 1033 that the proceeds be used to purchase replacement property which will, in effect, carry the old basis and will be sold within a relatively short period.

However, we realize that in the current H. R. 8300, it is desired to avoid as much as is possible, controversial amendments. Therefore, we do not propose to press at this time the issue of drought. The question of poisoning, injury, and disease, however, would seem to be less controversial, and entirely justified not as an extension of the present section 112 (f) but as a clarification of it in order to avoid controversies which are presently threatened by reason of the Service's unduly narrow construction of the section.

As an example, we would like to refer to a situation which arose during 1953, chiefly in Texas, but also in Oklahoma and New Mexico when many thousands of cattle were poisoned by cottonseed cake which, in the process of manufacture, became contaminated with chlorinated napthalene. When fed this cottonseed cake, the cattle developed a condition known as hyperkeratosis, and slowly, but inevitably died, unless the condition was discovered in time for them to be slaughtered for whatever salvage value they would bring. The herds of many cattlemen were completely wiped out. Others were seriously, though not so disastrously, affected. The Internal Revenue Service has erroneously, we think, ruled section 112 (f) inapplicable, and our request for reconsideration has rested without action in the Bureau for many months. Even though the original ruling may be modified, there are indications that it will not apply as broadly as we feel that it should; that it may, for instance, apply only to animals actually dying of the poison and exclude those sold for salvage value in mitigation of damages, an utterly unpractical distinction. Accordingly, we urge that section 1033 be amended to include "livestock held for draft, breeding or dairy purposes, or other use in the trade or business, compulsory or involuntarily converted as a result of poisoning, injury, or disease." As in all other matters, the Internal Revenue Service could protect the revenues by requiring strict proof by veterinarian or other testimony as to the cause.

We wish to thank you and the other members of the Senate Finance Committee, as well as your staff members and those of the Treasury, for your courtesy and patience in connection with these hearings and our proposed amendments.

Very truly yours,

NATIONAL LIVESTOCK TAX COMMITTEE,
By STEPHEN H. HART, *Attorney*

MEMORANDUM FROM THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS RE INTERNAL REVENUE CODE OF 1954 (H. R. 8300, 83D CONG., 2D SESS.)

The National Association of Life Underwriters, a trade association representing a membership of approximately 60,000 life-insurance agents, is submitting this memorandum to your committee for the purpose of pointing out certain defects in H. R. 8300, as passed by the House of Representatives, and suggesting the manner in which these defects ought to be remedied.

1. SECTION 101 (b) (2) (B)

In its present form, subparagraph (B) of section 101 (b) (2) would make the $5,000 income exclusion provided by subsection (b) (1) and (2) (A) applicable to certain employee death benefits paid by a qualified profit-sharing or stock bonus trust, but would deny this exclusion to similar payments made by qualified pension trusts or under employee annuity contracts meeting the requirements of section 401 (b). In our opinion, this would create an unwarranted discrimination against pension plans, both trusteed and nontrusteed. Accordingly, we recommend that subparagraph (B) of section 101 (b) (2) be amended to read substantially as follows (delete matter in brackets; new language in italic):

"(B) Nonforfeitable Rights.—Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than total distributions payable, as defined in section 402 (a) (3), which are paid to a distributee, by a *pension*, profit-sharing or stock bonus trust described in section 501 [(a)] *(e)* which is exempt from tax under section 501 (a) within one taxable year of the distributee by reason of the employee's death, *and other than total amounts payable under an annuity contract which meets the requirements of section 401 (b) within one taxable year of the payee by reason of the employee's death*)."

2. Section 101 (d) (1) (B)

Under subparagraph (B) of section 101 (d) (1), the so-called interest element in the proceeds of life insurance payable in installments would become taxable income in the hands of a beneficiary to the extent that such interest element, for the taxable year in which received, exceeded $500, where the beneficiary was the surviving spouse of the insured, or $250, where the beneficiary was an ancestor, lineal descendant, stepchild, adopted child, son-in-law or daughter-in-law of the insured.

We are confident that your committee is fully cognizant of the extreme social desirability of encouraging insurance beneficiaries to receive life-insurance proceeds in periodic installments, rather than in lump sums, in order to minimize the risk that such proceeds may be dissipated as the result of unwise investments and similar causes. It is largely because of this social concept that the Congress has until now deemed it appropriate to maintain the complete exclusion of the interest element from gross income; and we trust that your committee will seriously consider the need for placing any sort of limitation on this exclusion.

However, if you agree with the House of Representatives that such a limitation is necessary or desirable at this time, it is our opinion that the limits presently contained in H. R. 8300 are far too restrictive and will, therefore, tend to undermine the highly important social concept referred to above. Therefore, we recommend that if limits are to be imposed, the $500 and $250 figures contained in subparagraph (B) of section 101 (d) (1) be replaced by $1,500 and $750, respectively.

3. Section 402 (a) (4)

Section 402 (a) (4) provides that if a qualified employees' trust purchases insurance contracts, including retirement income contracts, with life-insurance protection payable on the death of the participating employees, or pays any part of the cost of such insurance contracts, no part of the premiums paid for such contracts shall be taxable currently to the employees, but that the entire insurance proceeds, when distributed, shall be taxable under the general rule applicable to the taxability of distributions from a qualified trust.

We have given this provision particularly searching consideration, and while we feel that there may be much to be said in its favor, it is our present judgment that the interests of employee participants in insured trusts and of their

beneficiaries will best be served by retaining the allocation rules of existing law, as set forth in PS No. 58 and I. T. 3993. Accordingly, we recommend that section 402 (a) (4) be amended to read substantially as follows (delete matter in brackets; new languge in italic):

"(4) CERTAIN LIFE INSURANCE CONTRACTS.—If a trust described in section 501 (e) *or section 403 (c)* which is exempt from tax under section 501 (a) purchases life insurance *or endowment* contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants, [or pays any part of the cost of such insurance contracts, no part of the premiums paid on such insurance contracts] *the cost (determined by regulations as prescribed by the Secretary or his delegate) of the current life insurance protection in excess of the reserves under such insurance contracts, after deducting so much of the contributions of the employee participants as may be allocated to such life insurance protection*, shall be taxable to the employee participants *in the year when paid, and* [but] the proceeds, when distributed, shall be taxable under paragraph (1) or *paragraph (2)* of this subsection *to the extent of such reserves.* [This paragraph shall not apply to group term insurance contracts.]"

Incidentally, you will note that we also suggest the deletion of the last sentence that now appears in the above paragraph. We see no reason why a group term life-insurance contract purchased by an employees' trust should be treated differently for tax purposes than individual contracts so purchased. In this connection we call attention to the fact that no such distinction exists under present law.

If section 402 (a) (4) is amended as we recommend, then for the sake of complete clarity, we also recommend that the last sentence of section 101 (a) be amended as follows:

"*That part of the* [The] proceeds of *any* life insurance *or endowment* contract [contracts] which is includible in gross income under section 402 (a) (4) shall not be excluded by this subsection but shall be treated as *an amount* [amounts] to which subsection (b) applies."

4. Suggested additional amendment to section 402

Under section 39.165–6 (a) (2) of Treasury Regulations 118, if a qualified employees' trust purchases an annuity contract for a participating employee and later distributes the contract to him, any cash surrender value that the contract may provide is not considered income to the employee unless and until he surrenders the contract.

On the other hand, under mimeograph 6461 and PS No. 66, an employee is deemed to have received taxable income by reason of the mere distribution to him by an employees' trust of a life-insurance contract, to the extent that the value of the contract may be applied to continue insurance, even though he does not surrender the contract.

We do not believe that there is any good reason why the same tax treatment should not be accorded to life-insurance contracts in such cases as is given to annuity contracts. Moreover, we respectfully submit that, as a practical matter, the complicated rules laid down in PS No. 66 for the determination of the taxable value of life-insurance contracts in such cases make it highly likely that the cost of effectively administering these provisions more than offsets any resulting gain in Federal revenue.

In these circumstances, we recommend that there be added to section 402 a new subsection designated as "(c)" and reading somewhat as follows:

"(c) Notwithstanding anything to the contrary contained in section 401 of this section, an employee shall not be considered to have realized taxable income merely by reason of the transfer to him of title to any life insurance, endowment, or annuity contract purchased for him by his employer or former employer or by any employees' trust in which he is, or formerly was, a participant."

5. Section 404 and section 7701 (a) (20)

These two sections (which duplicate each other) are practically identical to section 3797 (a) (20) of the 1939 code (which was added to that code by the Revenue Act of 1951), and each provides that for the purposes of applying the provisions of subtitle A of H. R. 8300 with respect to contributions to or under a stock bonus, pension, profit-sharing or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, the term "employee" shall include a "full-time life-insurance salesman" who is considered an "employee" for social-security purposes.

By way of background information concerning the enactment of section 3797 (a) (20), we should like to point out that the determination as to whether a given full-time life insurance salesman who operates on a purely commission basis is to be considered an "employee" (in the common-law sense of the word) or an "independent contractor" often depends upon relatively subtle factual nuances. Therefore, in the absence of express statutory language such as that contained in section 3797 (a) (20) of the 1939 code, a serious question existed prior to its enactment concerning whether or not it would be possible, in many cases, for companies employing such salesmen to qualify stock bonus, pension, profit-sharing or annuity plans in which they were participants.

We believe that similar problems may arise under H. R. 8300 in connection with (1) the application of the $5,000-income exclusion provided under section 101 (b) to death benefits payable to the beneficiaries or the estate of a deceased "full-time life insurance salesman," and (2) the qualification of accident and health plans under section 105. Accordingly, we respectfully request that section 7701 (a) (20) be amended to read as follows [new matter in italics]:

"(20) EMPLOYEE.—For *the purpose of applying the provisions of sections 105 and 106 with regard to accident and health plans and section 101 (b) with regard to employees' death benefits, and for* the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock-bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, the term 'employee' shall include a full-time life insurance salesman who is considered an employee for the purposes of chapter 21, or in the case of services performed before January 1, 1951, who would be considered an employee if his services were performed during 1951."

Furthermore, since, as we have pointed out above, section 404 duplicates section 7701 (a) (20), we suggest that section 404 be deleted.

6. Section 501 (e)

We can readily visualize situations in which this section would work tremendous injustices where small- or medium-sized employers are concerned. These situations could easily arise, for example, where such an employer's unionized employees elected not to come under a contemplated pension plan offered by the employer or had their own separate plan. In many such cases, section 501 (e) (3) would completely prevent the employer from setting up a plan for his nonunionized employees no matter how "nondiscriminatory" the plan might actually be in the circumstances. We are sure that the drafters of section 501 (e) did not intend to give rise to such highly inequitable results.

While we have given the matter a great deal of thought, we are presently unable to suggest specific, satisfactory, amendatory language which would enable employers in the above-mentioned types of situations to set up plans for their nonunionized employees that would "automatically" qualify as nondiscriminatory. We do suggest, however, that this may well be one area in which the Commissioner of Internal Revenue will have to be allowed to determine whether or not such plans are, in fact, discriminatory on a case-by-case basis and, in making such determination, to waive compliance with the "30 percent" or the "key employee" requirements if such waiver is necessary in order to reach an equitable decision.

7. Section 505 (a) (3)

This section defines, as allowable investments for an employees' trust, annuity contracts, or retirement income contracts in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan. We do not exaggerate when we say that we have received scores of letters, telegrams, and telephone calls from life insurance agents all over the country protesting against the unwarranted omission of ordinary and other forms of life insurance contracts as permissible investments for such trusts, inasmuch as such contracts have for many years been used, and are now being used, to fund such trusts.

We can think of no good reason why ordinary life insurance contracts should not be equally as permissible investments for employees' trusts as retirement income and annuity contracts, and can only assume that the omission to mention them in section 505 (a) (3) was purely an oversight on the part of the drafters of the section. Nor can we see any reason for a "100 times" limitation on the face amount of retirement income contracts purchased by a trust since this restriction would not limit the amount of death benefits that might be payable under an employees' trust, but only the amount of such benefits that might be insured.

We recommend, therefore, that section 505 (a) (3) be amended to read as follows (new matter in italics; material to be deleted in brackets):

"(3) annuity contracts, or *life insurance or endowment contracts* (*including* retirement income contracts) [in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan];"

Respectfully submitted.

GERARD S. BROWN,
C. L. U., Chairman, Committee on Federal Law and Legislation.
CARLYLE M. DUNAWAY,
Counsel.

DETROIT 23, MICH., *April 22, 1954.*

Senator CHARLES S. POTTER,
United States Senate Office Building,
Washington, D. C.

DEAR SENATOR POTTER: I am enclosing copy of a letter which you will find self-explanatory.

I respectfully request that you introduce an amendment which will provide income-tax relief for parents of these unfortunate children.

I am presently in Washington conscientiously attempting to initiate a reform in the law now before the Finance Committee (H. R. 8300) for review.

I shall be in Detroit again on May 7.

Your sincere interest and cooperation is respectfully and earnestly solicited.

Most respectfully,

MRS. PAUL J. SELINGER.

DETROIT 23, MICH., *April 22, 1954.*

CHAIRMAN OF FINANCE COMMITTEE,
United States Senate,
Washington, D. C.

GENTLEMEN: Last year a Mongoloid child was born to us (one of 300,000 in the United States). At the specific recommendation of three physicians, this child was placed in a home for care at a cost of $100 per month.

This year a deduction of $1,103 was disallowed on our income tax return on the basis that this child was not at the home for the primary purpose of treatment and I was given to understand if he had tuberculosis, cerebral palsy or any other affliction which today has a known cure or treatment it would be allowed under the present law. It is unfortunate that to date there is no relief for Mongoloids and many other congenitally defective children. However, since medical experience has proved the necessity for custodial care, I firmly believe the parents of such children should receive tax relief. This child was sent to us by God like a normal child and we wish to assume the responsibility for his care even though it means a long hard sacrifice.

It is our recommendation that serious consideration be given to this problem inasmuch as there are 5 million physically or mentally handicapped children in this country or 12.4 percent of school age children. With the increased birth rate the number will continue to grow and unless some relief is provided more of these children will be placed in public institutions at a cost considerably more than the $250 tax credit which would be allowed by the Government to parents.

Moreover, at approximately the age of six this child must be sent to a special school in the hopes that he can be rehabilitated. The States provide no special schools and so the parent is again faced with heavy expense for an undetermined period of years.

The tax allowance means a credit to us of approximately $25 for every hundred dollars expended or about $250, 2½ months of care.

We are aware of the abuses which might result from a revision of the law "for the medication and prevention of disease" but congenitally defective children are so seriously handicapped that custodial care is a necessity.

We respectfully request that serious consideration be given this problem in the revision of H. R. 8300.

Most respectfully,

MRS. PAUL J. SELINGER.

CITY OF BISMARCK, N. DAK., *April 12, 1954.*

Re Revenue bill, section 274, "Payments to Issuer of Tax-Exempt Obligations."

Hon. WILLIAM LANGER,
United States Senator, Washington, D. C.

DEAR BILL: The attention of the city of Bismarck has been called to the provisions of the above bill.

Apparently the proposed legislation is one more step in the attempted governmental control of municipalities and, if enacted, this section would seriously hamper the sale of certain municipal obligations and would almost require that our revenue bond issues be likewise backed by general obligations of the city.

I wish you would give some study to this provision of the proposed revenue measure and it is the desire of the city of Bismarck and the League of North Dakota Municipalities that you oppose all acts which would impose taxation of interest derived through the sale of municipal obligations.

With kindest personal regards to you, Bill, and a little warning: I have been seeing your picture on television; take it a little more easy if you can do so. I know you are hard to handle, you don't ever shut down, but, darn you, you will have to if you don't watch out for yourself a little.

Yours very truly,

C. L. FOSTER.

(Whereupon, at 1:10 p. m., the committee recessed to reconvene at 10 a. m. Friday, April 23, 1954.)

THE INTERNAL REVENUE CODE OF 1954

FRIDAY, APRIL 23, 1954

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

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

Present: Senators Millikin, Williams, Carlson, Hoey, and Long.

The CHAIRMAN. We shall now have put in the record a statement by Thomas Jefferson Miley, of the Commerce and Industry Association of New York.

Senator CARLSON. Mr. Chairman, if you have completed your insertions in the record, I would like to mention that the Kansas City Municipal Authority are somewhat concerned about the provisions in H. R. 8300 regarding taxation of airports. They hope to have clarifying language in section 274 to make it clear that it does not apply to State and municipal airports. And here is a very short statement of James M. Kemper that I would like to have made a part of the record.

The CHAIRMAN. It will be made a part of the record.

Senator CARLSON. I have a statement in the form of a brief, submitted in behalf of the Chicago Bridge & Iron Co., by their counsel, Walker B. Davis, in regard to the taxation of foreign income and the application of sections 923 and 951 of H. R. 8300, on construction activity, and I would like to have this studied by the staff and incorporated in the record.

The CHAIRMAN. All right.

(The statements referred to follow:)

MEMORANDUM

MARCH 11, 1954.

Subject: Provisions in the new tax bill pertaining to tax-free revenue bonds.

The Kansas City municipal authorities have been attempting to work out better facilities for airplane overhaul purposes at the new municipal airport and expect to rent these facilities to TWA, Braniff, and other lines that may be running in and out of the Kansas City Airport. The major lessee at this time would be TWA. Nothing is, of course, manufactured; and it is not contemplated that anything will be manufactured.

The operation is most important to Kansas City and to this area, however, as the facilities would do the major servicing operation for the entire line. TWA officials tell me they are very concerned about the language of the new bill as it comes out of the House committee for fear that—although in a general way they think they are excluded—the investment bankers say that the wording is so general that it might be construed on a contrary basis and that they would not want to undertake the sale of the Kansas City, Mo., Municipal Airport bonds without some clarification of language in this particular phase of the bill particularly emphasizing municipal overhaul bases and something that could be quite definite.

If this could be handled in the Senate committee, it certainly would not interfere with the spirit of the intended legislation.

JAMES M. KEMPER.

STATEMENT ON BEHALF OF CHICAGO BRIDGE & IRON CO., CHICAGO, ILL., BY WALKER B. DAVIS, SECRETARY AND COUNSEL ON TAXATION OF FOREIGN INCOME—APPLICATION OF SECTIONS 923 AND 951 OF H. R. 8300, THE PROPOSED INTERNAL REVENUE CODE OF 1954, TO CONSTRUCTION ACTIVITIES

The Chicago Bridge & Iron Co. is engaged, either directly or through subsidiaries, in the performance of construction work in foreign countries. The particular type of construction work done by this company is the erection of large steel plate structures—for example, tanks for storage of petroleum products at refineries and bulk plants and along pipelines. Sometimes the company fabricates steel erected abroad, but more frequently, especially in recent years, it erects steel fabricated by other producers.

The proposed Internal Revenue Code of 1954 authorizes a 14 percent credit against certain types of business income from foreign sources, as well as the deferment of foreign income in certain cases. These provisions seem highly desirable and in general well conceived to stimulate industrial activity and investment in foreign countries. It is a matter of concern, however, whether the wording of the pending bill will assure its benefit to American companies, such as the Chicago Bridge & Iron Co., which engage in construction work abroad.

Section 923 (a) (2) provides for the allowance of the 14 percent credit "with respect to taxable income derived from sources within any foreign country * * * as compensation for the rendition of technical, engineering, scientific or like service." The report of the Committee on Ways and Means makes it clear that this language is intended to cover "income derived from such services as the design or construction of projects such as roads, bridges, railroads, harbors, docks, irrigation systems, water supplies systems, and power systems." Although the statutory language should be considered in the light of the committee report, it would be desirable to make the statute itself so specific that reference to the committee report will not be necessary. This can best be accomplished by expanding section 923 (a) (2) specifically to include construction activities.

The deferment privilege granted by section 951 of the pending bill and the 14 percent credit granted by section 923 (a) (3) with respect to dividends from a foreign subsidiary are both limited to income which has been derived to the extent of 90 percent from "the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated in a foreign country." It would seem that these provisions in their present form discriminate against construction work performed by American companies in foreign countries. It is submitted that there is no rational basis for any such discrimination.

An American company which itself engages in construction work in a foreign country should be able to treat construction sites as a branch, but that would involve uncertainty where there are several construction sites and, therefore, as an alternative such a company should be able to establish headquarters in a foreign country from which its construction work in that country or countries will be supervised, and such headquarters should be considered a branch. If the construction work is done by a foreign subsidiary, income derived by the subsidiary from that type of work should qualify for the 14 percent credit as fully as income derived from a factory or mine or any of the other facilities or establishments now mentioned in the bill. That result could be accomplished by amplifying the list of facilities and establishments in section 923 (a) (3) (A) (ii) and in section 951 (a) which now begins with the words "factory, mine" etc., so as to include the phrase "construction headquarters."

Suggested modifications of the proposed code which would effectuate the recommendations included in this memorandum are as follows (new matter italicized):

"SEC. 923. BUSINESS INCOME FROM FOREIGN SOURCES.

"(a) ALLOWANCE OF CREDIT.—In the case of a domestic corporation (other than a corporation described in subsection (d)), there shall be allowed a credit as provided in section 37 with respect to taxable income derived from sources within any foreign country (determined under part I)—

"(1) as branch income includible in gross income under part IV;

"(2) as *income from construction activities or* compensation for the rendition of technical, engineering, scientific, or like services;

"(3) as dividends from a foreign corporation if—

"(A) the earnings and profits used in the payment of such dividend (including the earnings and profits of the year in which the dividend

is paid), determined under subchapter C (sec. 301 and following) have been accumulated after December 31, 1953, and are earnings and profits of a year the gross income of which year—

"(i) has been derived to the extent of at least 95 percent from sources without the United States,

"(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, *construction headquarters*, or other like place of business situated within a foreign country, and

"(iii) does not consist of more than 25 percent of gross income derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States,

but the credit shall apply only to the dividend or portion thereof paid out of earnings and profits conforming to the provisions of this subparagraph; and * * *

* * * * * * *

"SEC. 951. INCOME WHICH MAY BE DEFERRED.

"(a) IN GENERAL.—Any domestic corporation (other than a corporation described in subsection (c)) which during the taxable year operates a branch in a foreign country which is engaged in the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, *construction headquarters*, or other like place of business, situated within a foreign country, may elect, under regulations prescribed by the Secretary or his delegate, with respect to such branch, the treatment provided by this part, if such branch has, during such year, derived—

"(1) 95 percent or more of its gross income from sources without the United States (determined under part I),

"(2) 90 percent or more of its gross income from the active conduct of such a trade or business, and

"(3) not more than 25 percent of its gross income from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States. * * *"

COMMERCE & INDUSTRY ASSOCIATION OF NEW YORK, INC.,
New York 7, N. Y., April 21, 1954.

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

DEAR SENATOR MILLIKIN: Commerce & Industry Association of New York, Inc., representing over 3,000 member business firms in the New York area, submits this written statement in connection with H. R. 8300 because the 10-minute limitation on personal appearances would not afford adequate time to present the items covered.

The association, through its committee on taxation and public revenue, submitted many recommendations at a session with the Joint Committee on Internal Revenue Taxation in March 1953, and made a number of appearances and submitted statements at the hearings of the Ways and Means Committee last summer.

No attempt is made herein to cover the entire bill. The purpose of this statement is to set forth the association's views with respect to such of the particular provisions of the bill that the association has had time to look into. This statement is divided into part I, dealing with matters covered in subchapter C of chapter 1, subtitle A of the bill, and part II, dealing with matters in sections of the bill other than subchapter C.

PART I—SUBCHAPTER C (SECS. 301-391)

First recommendation.—Enactment of subchapter C should be postponed for 1 year to allow time for its study, existing law in this area to continue in effect.

The changes in subchapter C, dealing with corporate distributions and rearrangements, were not the subject of public hearings. They were inserted into the bill during the very late stages of its preparation, when the Ways and Means Committee was in executive session, without any opportunity for the

business community even to take a look at them, and with a very minimum of time for the members of the Ways and Means Committee and of the House of Representatives to study them.

There is in this bill a complete structural overhaul of rules of 30 years' standing in what is generally accepted as being the most complex area of taxation and at the same time one of the most significant in its effect on the economy.

Postponement is strongly urged to permit time for study by legislators, administrators and taxpayers, all of whom are entitled to acquaint themselves with the whole new set of rules before voting on them, administering them, or having to live with them. We have serious doubts that subchapter C would be enacted in its present form if adequate time were allowed for the careful consideration of its provisions and their effects.

Second recommendation.—If enactment of subchapter C is not postponed for further study, as above recommended, amendments should be made therein which will permit more flexibility and more freedom of action in corporate rearrangements, particularly in the case of small business. The proposed provisions, in many instances, operate as straitjackets and unduly restrict all small businesses in an effort to correct alleged abuses on the part of some. Corporate rearrangements, for purposes of expansion, diversification, greater efficiency, product improvement and the like, would be difficult, if not impossible, under the proposed bill. To alleviate some of the harshness and the restrictive provisions, and to permit some freedom of action on corporate rearrangements entered into for legitimate business purposes, the following 11 amendments to subchapter C are proposed:

1. Effective date should be advanced so that, at the very least, the new provisions would not apply to transactions completed prior to date of enactment or to transactions thereafter effected pursuant to contracts entered into prior to date of enactment (sec. 391).

2. Publicly held corporations.—Distinctions between publicly held corporations and all other corporations should be removed. Tax treatment should be based upon the nature of the transactions entered into, not upon the type of taxpayer. There is no sound basis for the discrimination. Furthermore, the line of division in the bill—10 or fewer shareholders who do not own more than 50 percent of the stock—is purely arbitrary. Many companies listed on stock exchanges would not be publicly held and many companies not listed on stock exchanges would be publicly held. If, however, this discriminatory treatment is retained in the bill, in determining whether a corporation is publicly held, stock held by a corporation should be deemed to be held by its shareholders (secs. 304, 354, 355, 359, 382).

3. *Mergers, consolidations, etc.*—The bill requires a nonpublicly held corporation to obtain at least 25 percent of the stock of the acquiring corporation in order for the merger to be tax-free. This would prevent small corporations (less than one-fourth of the size of the corporations into which they merge) from merging tax-free with large corporations. In the case of several corporations consolidating into one, the bill denies tax-free treatment if the shareholders of any one company receive more than 400 percent of the stock received by shareholders of any other company. This would prevent tax-free merger of several small corporations of different sizes. Both the 25 percent and the 400-percent restrictions (imposed by the bill on all corporations, except publicly held corporations) should be eliminated.

It is significant to note how the discrimination between publicly held corporations and other corporations would operate in this connection. Publicly held corporations could merge tax-free with other publicly held corporations. Nonpublicly held corporations could not merge tax-free, in perfectly valid business-purpose mergers, unless the 25-percent or 400-percent rules are complied with, simply because of their size. Because of the size differential, there would be two taxes upon the nonpublicly held merger—one on the transfer by the corporation of its property for stock, and another upon the shareholders exchanging their old stock for the new stock. In the publicly held situation, there is no tax at all—complete postponement of tax—and in the nonpublicly held situation, there are not one, but two, taxes (secs. 352, 354, 359).

4. *Redemptions of stock.*—(*a*) "Family-unit" rule: The bill introduces an entirely new concept of stock ownership under which a member of a family is treated as owning all the stock held by the family. Whereas there may be justification for the present rule disallowing losses on sales of stock to members of the family, there is no sound basis in fact or in law for a family-unit rule with respect to ownership. As the courts have held, ownership rests in the individual who holds the stock, not in the family to which he belongs.

This new rule disregards the facts of life. It presupposes that all members of a family are of a like mind with respect to their stock investments, that there can be no disputes or differences of opinion among members of a family, and that all their separate individual stock holdings are part of a common pool. It is based on the assumption that the money received by the member of a family who "cashes-in" his holdings in the family corporation in all cases finds its way back into the family pool.

Under subdivisions (3), (4), and (5) of section 302 (a) dealing with complete redemptions, substantially disproportionate redemptions, and redemptions by minority shareholders, the new family unit concept applies by reason of section 302 (c). Application of the family unit concept can operate to deny capital gain treatment on redemptions in ali three situations.

Our tax laws for many years have justifiably distinguished between distributions of dividends to stockholders who continue to hold the stock, and distributions made to stockholders who "cash-in" their stock. In the former case, the dividends on the stock are taxable in full as ordinary income, as long as they are paid out of earnings. In the latter case, there is a sale or a "turning in" of the stock and the amount received is received in exchange for the stock, not as income in the form of a dividend on the stock. The capital gains treatment in such case is the same treatment that the shareholder would have if he had sold his stock to an outsider, instead of selling it back to the company.

Complete redemption.—Under section 302 (a) (3), a shareholder redeeming all of his stock and completely terminating his status as a stockholder of the company would not be allowed capital gain treatment if other members of his family continued to own stock, unless for a period of 10 years after his redemption he neither remained on as, or became, a director, officer, or employee of the company, or reacquired stock in the company.

For example, a father could not redeem all his stock, put the money aside for his old age, and leave the business to be run by his children, if at any time during a 10-year period he stayed on or returned in an advisory capacity at a reduced salary. The theory behind the restrictions is that the money the father received on the redemption would find its way back into the company through the children. If he stayed on or returned during the 10-year period as director, officer, or employee, his gain on the redemption would be ordinary income, to the extent of earnings, instead of capital gain.

The treatment of all such redemptions as being "schemes" to obtain capital gains treatment for distributions of earnings fails to give any recognition whatsoever to the following factors: (1) the redeeming shareholder has parted with all of his stock, all of his voting power, and all of his rights to participate in the future earnings of the company. (2) Whether or not he may remain or return as an officer, director, or employee or even repurchase stock, is no longer a question of his wishes or desires, but he is at the mercy of the controlling stockholders, even though they may be members of his family. Certainly, by reason of the redemption, the redeeming stockholder's status has undergone a very drastic change. (3) The redeeming shareholder is paying a 25-percent capital gains tax on the redemption. (4) The gain on the redemption is attributable to the profits the company made which were taxed to it when earned. (5) The Treasury could benefit tax-wise from such a redemption by reason of the reduction in the salary of a redeeming shareholder who remains on in an advisory capacity. For example, a former $50,000 salary, deducted as an expense by the corporation, may be cut to $10,000.

Substantially disproportionate redemption.—Under section 302 (a) (4), a shareholder may redeem stock on a capital gains basis if he cuts down his common stock interest so that his percentage of the total common stock after the redemption is less than 80 percent of his percentage before the redemption.

A sole stockholder could not meet the test because no matter how much stock he redeemed, he would still own 100 percent before and after the redemption. But the objection to the provision lies in the fact that here also the "family-unit" rule applies by reason of section 302 (c). A member of a family is treated as owning the shares of other members of his family and is thus denied the right to act independently with respect to his own stock in a manner different from other members of the family. A redemption of more than 20 percent of his own stock would not meet the above 80 percent test because that percentage would be lower than 20 percent if the stock owned by members of his family is attributed to him.

Furthermore, the manner in which the 20 percent rule is applied is unduly harsh even in the case of shareholders who are not members of a family. The

stock that is turned in is subtracted from the total so that the denominator of the two fractions to be compared (which denominator represents the total stock of the company) is not the same before and after the redemption. Thus, if the total stock issued is 100 shares, held 25 shares each by 4 shareholders, and one shareholder turns in 10 shares for redemption, the before-redemption fraction of twenty-five one-hundredths must be compared with the after-redemption fraction of fifteen ninetieths to determine whether the percentage of the total after the redemption is less than 80 percent of the percentage of the total prior to the redemption.

Our recommendation is that the same denominator be used in both fractions, so that, in the above case, the two fractions to be compared would be twenty-five one-hundredths and fifteen one-hundredths. This could be accomplished by adding at the end of section 302 (a) (4) the following: "For this purpose, stock surrendered for redemption shall be considered as outstanding, whether or not the corporation cancels, retires, or holds it as treasury stock." Without such an amendment a more substantial shareholder would have to redeem a very large percentage of his holdings to comply.

Minority shareholders.—The stock of the shareholder that must be cut down by at least 20 percent to qualify as a substantially disproportionate redemption under section 302 (a) (4) is his "participating" or common stock. Section 302 (a) (5) allows a minority stockholder to redeem nonparticipating, or preferred, stock on a capital-gains basis. It provides that a shareholder owning less than 1 percent of the common stock may redeem preferred stock on a capital-gains basis.

Here, again, the family-unit rule applies by reason of section 302 (c). A member of a family owning less than 1 percent of the common stock could not redeem preferred stock on a capital-gains basis if his wife's or children's common stock plus his amounted to more than 1 percent.

In addition to elimination of the family-unit concept, on the ground that it has no basis in fact or in law, it is recommended that the 1 percent be increased to a more realistic figure. Defining a minority shareholder as one who owns less than 1 percent is unduly restrictive.

Shareholders in nonfamily corporations could be trapped by this provision. Assume that A, in New York, owned preferred stock, but no common stock, of a company having less than 200,000 shares of common outstanding. Unknown to him, his sons in California and Texas happen to own, together, 2,000 shares of common. If the company calls in the preferred for redemption, A would be denied capital-gain treatment because his sons' shares, attributed to him and amounting to more than 1 percent disqualify him from being a minority shareholder.

5. *Redemptions of nonparticipating stock.*—The bill includes a so-called cure for what has been referred to as the preferred-stock bail-out. In the recent Chamberlain Case a stock dividend of preferred on common was issued, the shareholders sold the preferred to an insurance company, and the insurance company shortly thereafter redeemed the stock.

The bill prescribes an 85 percent transfer tax to be imposed on the corporation based on the amount paid out in redemption.

The provisions of the bill, however, are broad enough to include redemptions of all preferred stock issued as a dividend, or even issued for property if the amount paid on redemption exceeds 105 percent of the amount paid in for such stock. The 85 percent transfer tax would apply to the excess over 105 percent. The transfer tax would apply in the case of all such redemptions made within 10 years after date of issuance. For this purpose, preferred stock issued at any time prior to January 1, 1954, would be considered issued on that date.

It is recommended that section 309, which prescribes the above treatment, be eliminated on the grounds (1) that this is not the proper method of handling the transaction; and (2) the so-called "cure" goes far beyond the situation in the Chamberlain case. The corporation, a separate entity, should not be subjected to an 85 percent excise tax on the transfer, by reason of the action of certain of its shareholders. The section as written would apply to presently issued and widely held preferred stocks purchased for cash by the investing public, where the redemption price exceeds 105 percent of cost.

Section 309 (a) (2) of the bill prescribes an exception to the imposition of the transfer tax which would be impossible of performance in situations in which shareholders have disposed of the participating stock, or part of it, with respect to which the nonparticipating stock was issued.

As an alternative, it is suggested that recognition should be given to a standard form of sinking fund arrangement not in excess of 5 percent per annum, and that there be taxed as ordinary income, gain realized on the sale and on the retirement through use of a sinking fund in excess of 5 percent.

At the very least, it is recommended that the treatment in section 309 be applied only to nonparticipating stock that is issued as a dividend after the date of enactment of the new code.

6. *Redemptions through use of related corporation.*—Section 304 should be deleted and there should be substituted therefor present section 115 (g) (2) of the 1939 code.

As drawn, section 304 is intended to cover a situation which was rejected by the Finance Committee when a similar provision was included by the House in section 208 (a) of the Revenue Act of 1950. The present proposal, as in 1950, attempts to extend the Wanamaker case beyond the factual situation therein presented.

The present proposal should be rejected for the same reason that the similar proposal in 1950 was rejected.

Present section 115 (g) (2) of the 1939 code, the retention of which we advocate, was inserted to overcome the effect of *Comm.* v. *Wanamaker* (178 F. (2d) 10). That insertion had the approval of the Senate Finance Committee in the following quotation from its report:

"If the stockholders of a corporation which owns all the stock of a subsidiary corporation obtain cash from that subsidiary, in effect they have received a dividend to the same extent as would be the case if the cash had been paid by the subsidiary to the parent corporation and had then been distributed by the parent to the stockholders. And where such stockholders 'sell' part of their stock in the parent corporation to the subsidiary they nevertheless retain ownership and control of both corporations, since the 'sold' stock is one of the assets which the parent corporation owns by virtue of its possession of all the stock of the subsidiary. Therefore, section 209 of your committee's bill amends section 115 (g) of the code, so as to cover indirect redemption of shares in a parent corporation through purchases by its subsidiaries."

The Senate Finance Committee, in 1950, refused to extend the application to the so-called class-B applications and the law as finally passed did not extend it to them. As to such extension, the Senate Finance Committee in 1950 stated:

"The House bill also extended the application of section 115 (g) to cases in which both the issuing corporation and the acquiring corporation are controlled directly or indirectly by the same interests. Your committee eliminated this provision because in this case it is not clear that the effect is the same as a redemption of stock by the issuing corporation."

Present section 304 attempts to accomplish this same extension which was rejected in 1950.

7. *Separate treatment of "inventory assets" in corporate redemptions and liquidations.*—In the case of redemptions under section 302 and partial and complete liquidations under sections 331 through 336, the bill prescribes a tax treatment for "inventory assets" as defined different from the tax treatment accorded to all other assets distributed in redemptions or liquidations.

The types of assets that are segregated for different treatment include not only assets which are commonly referred to as inventory assets, that is property which would properly be includible in inventory if on hand at the close of the year, and property held primarily for sale to customers in the ordinary course of business, but also include rights to income and property used in the business held for less than 5 years. Thus, real property used in the business which was held less than 5 years would be an "inventory asset," but real property used in the business that was held over 5 years would not be an "inventory asset".

The different treatments require that the stock being redeemed or retired in the liquidation be "attributed" to the different types of assets it represents, and that gain or loss, basis, and holding period be determined with respect to each class of asset. While the shareholder receiving "inventory assets" as defined generally takes over the corporation's tax basis of such assets, he is taxed upon disposition of such assets depending upon their character.

The new treatment is made even more complex by reason of the fact that the bill prescribes different rules for distributions in which (*a*) gain is recognized, (*b*) loss is recognized, and (*c*) no gain or loss is recognized.

Wholly apart from the complexities involved, there appears to be no sound basis for different tax treatments of assets received in redemptions and liquidations, some of which may have appreciated in value and others of which may have depreciated in value.

All assets distributed in redemptions or liquidations should be treated alike. Distinctions as to types of assets are proper while the business is being conducted. Sales of assets properly included in inventory should produce ordinary income, as they now do, but a distribution in liquidation is another matter.

The separate treatment may be justifiable only in the case of collapsible" corporations.

8. *Definition of partial liquidation.*—The definition of a partial liquidation now contained in section 336 (a) introduces an entirely new and unrealistic concept under which a corporation's activities are divided into separate businesses, with separate books of account, etc. Only a termination of such a separate business would qualify as a partial liquidation.

This new definition precludes a general contraction of the entire business from being treated as a partial liquidation. It also precludes a company doing business in several States from qualifying the abandonment of operations in one or more States as a partial liquidation. The "separate-branch" concept limits partial liquidations to a highly restricted and extremely narrow field, because, except in a comparatively few instances of large corporations, with "divisions" separately operated for 5 years or more, business in general is not conducted in that manner.

The new definition should be deleted and replaced with a more realistic definition that takes into account standard methods of doing business that are employed by corporations in general, rather than methods employed by a very small segment of the country's corporations.

9. *Definition of "securities."*—The definition of "securities" in section 312 (c) of the bill should be amended to read as follows:

"The term 'securities' means an instrument representing an unconditional obligation of a corporation to pay a sum certain in money at maturity."

10. *Definition of "dividend."*—The bill leaves out the qualifying word "made" from the definition of "dividend" in section 312 (a) (1). The omission could be construed to make dividends taxable when declared rather than when made, forcing accrual basis taxpayers to investigate in every instance when the dividend was declared, rather than simply, as under present law, including dividends as income when received.

Section 312 (a) (1) should be amended to read: The term "dividend" when used in this subtitle means a distribution made (as determined in section 301 (a)) etc.

11. *Limitation on net operating loss carryovers.*—Section 382 arbitrarily reduces the amount of the net operating loss deduction in the ratio of the percentage of new stock ownership where there is a change in stock ownership of at least 50 percent. "Publicly held" corporations are excepted, so that only the nonpublicly held corporations are penalized.

The purely arbitrary penalty would prevent many going enterprises which are in need of new capital from obtaining such equity financing. Rather than being penalized, they should be encouraged to continue in business and maintain employment.

Since, as above pointed out, some corporations listed on stock exchanges would qualify as "publicly held" and others so listed would not, the former would not be penalized and the latter would. This is rank discrimination even between the larger type corporations, in addition to being discrimination between corporations whose stock is widely held and those whose stock is closely held.

In place of the arbitrary disallowance based on percentages, there should be substituted a provision permitting discretionary authority on the part of the Secretary or his delegate, as is done in section 269 of the bill in the case of mergers with "loss" corporations.

No "cure" for the "trafficking in loss corporations" abuse is acceptable if its effect is to prevent going companies that have encountered difficulties from continuing in business and maintaining employment through the infusion of new capital and new personnel, whether the new "blood" represents 49 percent or 51 percent of equity ownership.

PART II—SUGGESTED AMENDMENTS OF PROVISIONS OTHER THAN THOSE CONTAINED IN SUBCHAPTER C

12. *Acceleration of corporate income tax payments.*—Sections 6016 and 6154 require corporations to estimate and pay income taxes during the current year before the net income for the year is determined, where the tax is estimated to exceed $50,000. There are many factors which make it difficult or practically

impossible for a corporation to estimate its net income and its tax before the end of the year. In fact, in the usual case it takes several months after the close of the year before all the figures can be assembled.

The net income of a corporation using LIFO inventory depends on the valuation of such inventory, which, in turn, depends upon BLS indexes which are issued only twice a year. Fluctuations in such figures materially affect net income, yet such figures will not be available for purpose of estimates before the close of the year.

In the case of department stores and other retail establishments, working capital will be depleted during the last 4 months of the year, which is the very time such capital is needed for large inventories to accommodate the Christmas trade.

The cost of borrowed funds to meet estimated tax liabilities will have to be added to the cost of doing business. These added costs will in turn be reflected in the price of goods to the consumer.

Corporate income-tax payments are now in the process of being accelerated under the Mills plan. It is recommended that the present system of acceleration be continued, but that the additional acceleration prescribed by the bill be eliminated.

13. *Real property tax accruals.*—The proposed bill permits a taxpayer to accrue deduction of real property taxes on a monthly basis, based upon the property tax year. However, as the law is written, a gap would occur in making the switch from the present method of deduction to the new type deduction. To illustrate, a fiscal-year taxpayer is on a January 31 year. The "lien" date governing the 1953 deduction was July 1953 and applied to the property taxes covering 1954. The 1955 taxes will not begin to accrue until January 1, 1955. This would result in only one-twelfth of the real property tax being deductible in 1954.

It is recommended that the bill be changed to provide that the new method be optional, and that a taxpayer who has consistently employed a method of deducting real property taxes and which method is proper under the present code, be permitted, at his option, to continue the use of such method.

14. *Personal holding companies—consolidated returns.*—It is recommended that secrtion 542 (b) of the bill should be deleted and the following should be inserted in its place:

"If the common parent corporation of an affiliated group of corporations making a consolidated return under the provisions of section 1501 satisfies the stock ownership requirement provided in section 542 (a) (2), and the income of such affiliated group, determined as provided in section 1501, satisfies the gross income requirement provided in section 542 (a) (1), such affiliated group shall be subject to the surtax imposed by this subtitle."

(The above provisions are derived from section 501 (c) of the 1939 code.)

Present law (sec. 501 (c)) applies only if the common parent corporation is a common parent of an affiliated group of railroad corporations. This restriction is contained in the last sentence of present section 501 (c).

There appears to be no necessity for the unduly complex provisions of section 542 (b) of the new bill, when the objective can be accomplished simply by repeating present law with the last sentence deleted.

15. *Deferment of action on pension and profit-sharing provisions.*—The provisions dealing with pension and profit-sharing plans introduce several new concepts, the effect of which requires further study.

For instance, after describing various classifications of employees that may be covered, the bill provides that a plan will be discriminatory if more than 10 percent of the participants are key employees. Key employees are the 10 percent in the highest pay bracket (but not more than the 100 highest paid). The bill provides that the plan will not be considered discriminatory if it covers 25 percent or more of all employees regardless of the number of key employees covered.

In practice these provisions will make it almost impossible for a small corporation to set up a qualified plan for the salaried group. The average sized and moderately large corporation will have less than 1,000 employees in the salaried group. Since the predominant portion of key employees in any corporation is normally found in the salaried group, the corporation would undoubtedly find that its plan was considered discriminatory under the 10-percent key-employee rule. Therefore, it would have to rely upon the overall 25-percent test.

However, in the typical manufacturing company the number of hourly paid employees would greatly exceed the number of salaried employees, and it would be unusual if the ratio were not greater than 3 to 1. It would therefore be impossible to qualify a plan for salaried employees unless the number of employees in the salaried group exceeded 1,000. Enactment of these provisions should therefore be deferred at least 1 year.

16. *Amendment to definition of "foreign income tax."*—For purposes of allowance of credit for foreign taxes, an income tax should include any tax which is imposed on or measured by income, whether or not income in the foreign country is computed on the same basis and with the same deductions as used for computing income in the United States, and any tax which is in lieu of an income tax. This should be in addition to the provision permitting the deduction of a principal tax.

17. *Amendment to definition of foreign establishment.*—The proposed bill extends a 14-point tax benefit to income from sources within foreign countries. The bill then describes those businesses in foreign countries which will qualify for the tax benefit.

Our recommendation is that the description of various businesses and industries qualifying for the benefit is too restrictive and that the tax benefit should be extended to include all types of businesses and industries operating from a permanent establishment in a foreign country.

In making these recommendations, Commerce and Industry Association has been cognizant of and heartily supports the aim of this committee and the administration to write a tax law that will encourage and aid business throughout the country to the advantage of the national economy. However, in the limited time enabled for study of H. R. 8300, no one can be certain as to the effects some sections of it will have on business.

We urgently request, therefore, that time for adequate study be permitted, particularly of the controversial sections, in the earnest belief that should it be denied for the sake of expediency, resulting economic problems and restrictives may have serious impact on business and the economy that will be felt for years.

Sincerely yours,

THOMAS JEFFERSON MILEY,
Executive Vice President.

The CHAIRMAN. Mr. Madden. Be seated, Mr. Madden, and identify yourself to the reporter. We are glad to have you here.

STATEMENT OF JAMES L. MADDEN, FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. MADDEN. Thank you, sir.

Mr. Chairman, my name is James L. Madden, chairman of the taxation committee of the Chamber of Commerce of the United States.

I have a prepared statement, and, with your permission, I would like to put it in the record and just telescope what I have here in the interest of time.

The CHAIRMAN. It will be put in the record.

Mr. MADDEN. And there will be a detailed brief attached thereto.

The CHAIRMAN. That will be made a part of the record, also.

Mr. MADDEN. Thank you, sir.

I think we might open our testimony, Mr. Chairman, with a brief statement of our general economic situation in the United States, because the taxation program which you gentlemen might ultimately decide on should be measured in terms of our economic welfare. Our country has great possibilities for future growth, and it is only proper that the places where the taxation program might tend to lessen this growth should be given very careful consideration.

The country is going through an economic adjustment from an inflated wartime economy to our normal peacetime basis of operation.

The adjustments seem to be taking place in an orderly manner, and there is promise of stabilization on a high level of peacetime production. It is our viewpoint that we are going to stabilize at a very high level of production if impediments can be taken out of the way of the development of business.

The country is fundamentally strong. The gross national product, according to the President's Council of Economic Advisers, was running at an annual rate of $350 billion——

The CHAIRMAN. That was last year, do you remember?

Mr. MADDEN. Yes, sir; I remember. There was about a 3½-percent shrinkage from last year. So, on an overall basis, the shrinkage is low.

Now the level of employment is around 61,500,000, about a million and a half less than last year. So you can see on a percentage basis again the overall picture is certainly very encouraging.

The backlog of personal savings—I doubt if this is appreciated very often—of the people, exclusive of Government securities, is at an all-time high of $380 billion.

The CHAIRMAN. How much?

Mr. MADDEN. $380 billion. This was at the end of last year. And there are good reasons for thinking that sum will continue to grow.

The CHAIRMAN. You have as much savings as 1 year's gross national product.

Mr. MADDEN. That is about right; yes, sir.

Now this picture is very encouraging. On the other hand, it does not portray the lack of balance in important segments of the economy, because it does not reveal the extent to which the success of some businesses tend to offset the loss. And that is very important, because there is an adjustment process going on right now from a wartime economy to a more normal peacetime economy. We must keep in mind that, from the standpoint of our peacetime prosperity, we have got to go ahead and get the stabilization on a high basis. We think this can be done. But we do think impediments have to be taken out of the way of the economic processes to achieve that.

Granting a strong basic economy, one must recognize the problems of economic adjustment to more normal peacetime levels by business generally and particularly by those segments in our economy which are out of balance at the present time.

Equally important is an appreciation of some of the overall weaknesses in our economy which could spell serious trouble in the future. High among these is the matter of inflation, and that is extremely important because it is a trend that seems to go through our whole economic situation.

Inflation is certainly a major problem, a most serious problem, and one which our Federal tax policies can help to curtail by ceasing to sap the vitality of our business structure at a time when it needs capital, particularly equity capital. How far we have gone along the road of inflation is seldom fully grasped by the man in the street.

The National Industrial Conference Board tells us that construction, total private construction, last year amounted to $25 billion. Yet, the same amount of work in terms of 1939 dollars could have been done for $10 billion. That is exteremely important to keep in mind because it means with the equipment today there has to be so much more money available.

The CHAIRMAN. I think there is probably more appreciation of that than one might think, because the lady with the market basket has that problem, especially if the family lives on a fixed income.

Mr. MADDEN. That is right.

Production of course is one of the key answers to inflation. It also helps provide jobs, and throughout my brief summary of these remarks we keep banging away at the fact that a high level of production means jobs. And businessmen are just as much interested in keeping a high level of employment as anybody else.

Many remarks or suggestions we make in connection with H. R. 8300 have to do, one way or the other, with helping to ease the flow of equity money into the economic structure, and also to remove the inequities.

We think that H. R. 8300 is in the right direction. We think the fundamental philosophical basis of this bill is sound. The principles are thoroughly sound, because they help remove those things which impair or interfere with orderly development of the United States. We think we have grown big. Large sums of money are necessary to develop the St. Lawrence waterway, to develop, for example, through private utility companies the power for atomic energy. Think of what is going on in Minnesota in the way of helping to develop taconite——

The CHAIRMAN. Helping to develop what?

Mr. MADDEN. To develop taconite. Because the high-grade iron ore supply has been pretty well washed out they are using a concentrate. That takes a lot of money.

In other words, because of inflation the sums are fantastic, but they have to be gotten if we are going to continue to progress in the United States, which we believe we will.

We start off with the idea that H. R. 8300 fundamentally is a big step in the right direction, and fundamentally it is sound from the standpoint of taxation, and is certainly sound from the standpoint of helping to promote a sound basis for further development.

The complications arise from the fact that the scope of the Government's operations have become so huge and the revenue necessary to support those operations are so big that the amount of relief, the amount of the removal of inequities, which the administration would like to have, is necessarily limited.

So this bill, in our viewpoint, must be regarded as just a step, you might say, to keep in tune with current needs and our national development. It should be viewed as a constructive effort along those lines, but not as a complete overall answer.

Equity capital is vitally important in the current adjustment of business and the further development of business. As industry becomes more and more competitive, its ability to operate on a low unit cost basis and to develop new products and services is directly related to the new capital that can be secured. New capital helps to make possible the purchase of new equipment, facilities, and structures and the replacement of the old. Many firms have found it very difficult, as you know, Mr. Chairman, in the immediate past because of inflationary trends and the effect they have upon the firm's ability to replace equipment.

The matter is further complicated by the fact that, in the latest figures from the National Industrial Conference Board which we

have been able to secure, it takes about $10,000 capital investment per worker to provide a job——

The CHAIRMAN. As an average.

Mr. MADDEN. That is an average figure; yes. And, of course, that is a 1950 figure for manufacturing concerns. Obviously it would be much higher today.

Corporate debt is now up to $190 billion. But, coming back to our matter of needs for capital, equity capital particularly, the ratio between debt and new equity financing since the war has been $3.20 to $1. That is not a good ratio. It is unbalanced. Firms like to go ahead and have a 50–50 ratio, if they can.

The CHAIRMAN. Business is financing itself out of its own earnings and out of the debt, isn't it?

Mr. MADDEN. That is right, but that is not too good. It is largely because of the tax bills in the past that investors have been discouraged from going into equity capital investment. Investors seem to prefer the safety of a bond yield, averaging somewhere around 2½ or 3 percent, to risk capital investments, and yet this country was built with risk capital.

To attract equity capital, according to the stock exchange, the law of supply and demand last year forced returns of about 6.3 percent. You see the spread between the two, but in order to complete the picture, that 6.3 percent is misleading because by the time you take out taxes, it is not inviting at all.

In some way, as we see it in the United States Chamber, we must progressively remove these hurdles on the matter of common-stock investments. Now, we folks in the chamber of course feel that this whole situation is one reason for the——

The CHAIRMAN. Have you any statistics as to the equity offerings over a period of time?

Mr. MADDEN. I will be very happy to get them, sir.

(The information requested was not received in sufficient time to be included in the hearings.)

Mr. MADDEN. The chamber feels that the tax on capital gains should be eliminated, and we think it can be eliminated. We realize of course, that it can't be done all at once because of the budgetary needs of the Government. But we feel ultimately it should be eliminated and that some kind of a start should be made in order to help provide business with the funds which are so necessary for the ultimate development of our country.

Of course this bill, H. R. 8300, is good in many other ways. For example, in regard to depreciation reserves. A lot can be said about depreciation reserves, but the cold facts are, regardless of the views, that businessmen have to have some means of setting up depreciation reserves in order to go ahead and buy new equipment when the useful life of existing equipment is gone.

As far as the chamber is concerned, we realize the importance of this particular subject. Estimates of the Treasury have indicated that if we had a realistic——

The CHAIRMAN. What did you say there?

Mr. MADDEN. Will you read that back, please?

The REPORTER (reading):

Estimates of the Treasury have indicated that if we had a realistic——

Mr. MADDEN (continuing). If we had a realistic depreciation policy our national industrial plant could produce an extra $7 billion worth of new equipment and junk some of the old. This would place many concerns in a stronger competitive position, and would help assure jobs for employees and help reduce prices.

The United States Chamber realizes only too well the necessity of realistic tax legislation and administrative methods on depreciation, and we realize, again, that it has to be approached gradually because of the budgetary requirements of the Government.

H. R. 8300 makes a step in that direction. We think that the administration and the House are to be congratulated upon coming to grips with this particular matter. Of course it isn't quite as far as we would want to go, but we realize also that we won't accomplish these objectives overnight.

Now, as far as we are concerned, of course——

The CHAIRMAN. You can't expect to go to heaven in one jump.

Mr. MADDEN. That is the idea. We would like to get there, you understand, but we are perfectly willing to take our time.

The chamber believes that the full costs of depreciable property should be recoverable free of tax as rapidly as is reasonable, and that the depreciation claimed by the taxpayer, in accordance with computations used in his books, should be accepted unless clearly unreasonable. That gives plenty of latitude for different kinds of methods. One method set forth in H. R. 8300 conforms to a degree with that particular objective. We may be able to improve it over a period of time.

The declining-balance method set forth in the bill is in the right direction, and we feel the drafters of the bill ought to be commended for starting an effort along those lines.

Another major source of funds to help business meet its capital needs is private investors. The tax laws definitely have discouraged private investments in equity stocks. In the opinion of the chamber, H. R. 8300 makes a step in the right direction in this matter of removal of double taxation. It can only go so far, however. Again you have the matter of budgetary needs, and we have to be reasonable, as I said, and we want to go to heaven, so we have to take our time. Maybe the road is rocky, but in any event we will get there. But we think this bill is in the right direction.

The matter of equity capital is extremely important to business, as I said before. There is a lot of material published on that. United States Steel, for example, has put out a statement in its annual report which I think is very indicative. It shows that the Government is taking 59 cents out of every potential dividend dollar. Of course the question comes up: How long can the Government expect the necessary flow of new capital to business, under these circumstances? That, in our judgment, is a very important factor in the ultimate development of our country.

We believe that elimination of double taxation would lead to a greatly increased flow of capital in this kind of business, and we mean jobs too.

The testimony against the double taxation of dividends leads one to think that this is a provision set up essentially to help the rich. But of course that is not so. Two hundred thousand employees at

American Telephone & Telegraph Co. would be quite surprised, I think, if they were told they were rich; and particularly the 70,000 stockholders of American Telephone & Telegraph who only have 1 share. They would be quite surprised, and so would the 56 percent of the stockholders of United States Steel, whose average income is about $2,800 annually. In other words, that allegation is certainly without foundation. Our statistics can be quoted right down to cases, and it doesn't bear out the contention of those who are opposing this provision of the bill.

The cold facts are that the people who oppose this provision want jobs, but they refuse to let business have the wherewithal—the equity capital—to go ahead and do the best kind of a job they can in the way of producing at low unit cost and providing high levels of employment. You cannot have that unless there is adequate equity capital.

Now, there is another angle to this whole thing: According to the March report of the Council of Economic Advisers, the Federal Government took about 54.6 percent of the corporate profits before taxes in 1953. Now, that is thoroughly understandable, but if, as the chamber believes, the future of our economy is being built in part today, this percentage has to be drastically reduced if business is to have adequate funds not only to take care of the present adjustments to peacetime levels but also to lay a base for even greater service to the public in the future.

Remember, Mr. Chairman, we think that the American future is ahead of us. We think the expansion of the United States is ahead of us if we have brains enough to follow sound economic principles and not play around with one principle after another in an experimental kind of way. There is no substitute, in our opinion, for the Ten Commandments.

The CHAIRMAN. Let's agree to the Ten Commandments.

Mr. MADDEN. Yes; we do on that.

The CHAIRMAN. Well, proceed from that point on. How do you answer the suggestion that with these taxes that we're complaining about, the industrial machine of the United States has made tremendous advances—has been adequate to promote and take care of our needs?

Mr. MADDEN. My answer to that is that we did not have full employment, Senator, until we had World War II. We had World War II and then a postwar expansion to take care of the deficits and consumer demand during World War II and then we had Korea. In other words, for the first time in many years, we have the opportunity to shake down to a normal peacetime economy which will provide high levels of employment.

My answer to your statement, therefore, is that what has been happening in the last 13 or 14 years—we can't say that, but say since 1941 and 1942—what has been happening since then has been in one way or another directly related to war or postwar expansion, and right now we are confronted with an economic situation which we think can be handled, if the necessary tax impediments are taken out of the way of business.

The CHAIRMAN. During the years that you refer to, how did industry get capital necessary to make its tremendous expansion?

Mr. MADDEN. All right, I will answer that. In the first place, I will have to remove depreciation. You know we had an unrealistic

depreciation policy up until 1942. In order to get production, you had to turn around your reserves, and the 5-year depreciation plan was put in, in order to accelerate the bricks and mortar to produce the raw material.

After the war was over a lot of that was obsolete. There has been a pent-up demand for a lot of consumers' goods, so there was more of the bricks and mortar. We have gotten by so far with a lot of businesses going too heavily in the direction of debt capital, instead of keeping a ratio which we think is between, and we think the day of reckoning is not too far off.

Now, another thing—and what you said was right also, in regard to retained earnings. Before the war, businesses would pay out about 75 percent of their earnings to their stockholders. Since the war they have had to tighten up one way or the other, in order to get the money, and the result is that dividend payments dropped down to around 50 percent of earnings, somewhere around that figure. The point is that one way or another they have gotten their money, but now the chips are down and the real peacetime opportunity is here and business welcomes it, because we have confidence in the future.

We also very definitely feel that a lot of these things have to be changed. It is all right when we probably had to have revenue for the Government for security purposes. It is all right to go ahead and do a little of this, that, and the other, although you realize it is not economical. But now we have a different proposition.

The CHAIRMAN. Are our expanded wartime plants suitable to take care of our peacetime needs?

Mr. MADDEN. No. Parts of it, of course, are, but a lot of it isn't.

Another angle on this thing: It isn't easy to accomplish what we have in mind and what you and your colleagues on the Finance Committee have in mind. It won't be easy because the Federal taxes last year took about 25 percent of our national income. That is a lot of money.

The CHAIRMAN. Well, of course we support payrolls and we buy material, and there is a lot of waste.

Mr. MADDEN. It includes social security, too.

If the economists know what they are talking about—and I am not an economist—that percentage is not a healthy percentage, and we believe that percentage can be taken down a little lower so we can feel at least we are not fighting tax dollars all the time, that we're putting the money into bricks and mortar and jobs.

The CHAIRMAN. I am in entire agreement with you. I just wanted to see what you had to say about it.

Mr. MADDEN. We feel very definitely that the provision in H. R. 8300, which has to do with the expiration of the 52-percent maximum corporate tax rate, is a good provision. We think that the drafters of that particular provision of the bill had their hands on the pulse of business, and the chamber feels very strongly that that particular provision should be carried out next April.

Now you see that is actually in line with the fact that the United States Chamber is essentially an organization of small and middle-sized corporations. Our policy is that the corporate normal rate should be reduced from 30 percent to 25 percent.

You would be surprised how many firms today cannot get money because there is no equity cushion underlying their request for debt

capital. Lenders have to insist on an equity cushion of reasonable proportions. Most State laws require it.

The CHAIRMAN. Where do you expect to get that equity capital?

Mr. MADDEN. We think it can be gotten from the public. With all the personal savings, there ought to be some way of getting that, and we think if the returns are adequate after taxes, the money will come.

Now, going further——

The CHAIRMAN. Don't go further too fast. This little fellow who has accumulated savings, are they giving him a chance to buy equity capital?

Mr. MADDEN. The stock exchange has a plan right along those lines right now, Senator.

The CHAIRMAN. Are they making an effective effort?

Mr. MADDEN. They are making the effort. In all fairness it is too soon to form a judgment on that. They certainly are making the effort. There is no doubt about that.

The CHAIRMAN. Do you think these savings are a field out of which to sell equity capital?

Mr. MADDEN. We think so.

The CHAIRMAN. But the average fellow that has $1,000 or $1,500 in savings, what does he buy and how does he proceed to buy it? What does he know about the subject of buying equity capital?

Mr. MADDEN. Well, I will say this: He can go to his local bank for advice and guidance and get pretty good advice. He can go to the stock exchange house. There are several stock exchange houses, as you know, with branches all over the country. They have made it their business of advising the small potential stockholders.

Also, as you know, there is an effort on the part of a lot of small-business men themselves, from the economic standpoint, to try to buy stock for protection against inflation. You have your insurance funds now supplementing their regular pension provision for teachers, by setting up an equity fund as protection against inflation.

In other words, there are a lot of movements underway now, and if they were given just a little encouragement, we think it would be very helpful to meet this need of business.

Now, I have been commenting in a most favorable way upon this bill, H. R. 8300. Any monumental job of that type—and it is monumental—is bound to have some criticism.

The CHAIRMAN. Tell us about it.

Mr. MADDEN. Well, I will submit a detailed brief, with your permission, which contains quite a statement.

The CHAIRMAN. It will be put in the record.

Mr. MADDEN. But the point I want to stress is, we think this bill is in the right direction. We think the basic philosophy is right and we think the philosophy is in line with what is necessary to get our economy on a high-level basis of production.

Now, I will skim over these other things. Acceleration of corporate tax payments is bad, because it offsets a lot of other good provisions of the bill. Remember, businessmen need money. Equity capital. A lot of them need it and, don't get me wrong, a lot of them don't. But along comes a provision which makes business borrow extra money, and the effect of this particular provision is that you really have a tax increase for about 5 years which is not good. Looking at it in terms of the national economic welfare——

The CHAIRMAN. Which provision is that?

Mr. MADDEN. The acceleration of corporate tax payments. We think that provision is unsound, and we hope that you gentlemen will see fit to drop it, because of the impact it has upon our further economic development.

Now you have the matter of depreciation provisions. Remember, I stress the fact that this is in the right direction. On the other hand, though, if the committee sees fit to approve this provision which we recommend, we hope the committee will indicate that the matter of the useful life and methods of depreciation or rates of depreciation should be in accordance with some type of plan as laid down by the Treasury, but not bulletin F, because we think that is unrealistic.

Going further, we think it would be grossly unfair to remove the benefits of the bill in regard to the double taxation of dividends. We think that the matter of taxing these stock, fire, and casualty companies is very unfair. We hope the committee will remove that inequity.

The CHAIRMAN. That has been brought strongly to our attention. I am not in a position to predict, but I think there is a lot of feeling on that, that it should go out.

Mr. MADDEN. As a matter of fact, Mr. Chairman, we have been trying to find out just how it got in the bill, because we don't find any reference at all in the report of the committee, and it is just an exception to the general principle which is so sound, that we didn't quite understand it.

Moving along further. This matter of accumulated earnings again brings us back to the economic picture. The provision in the bill is in the right direction. We are for it. On the other hand, however, it doesn't seem quite right not to go ahead and give business an opportunity to retain the funds it needs for the further expansion of business, or, if losing business, to go to an unrelated business in order to keep its plant going and keep employment up. Yet business concerns are afraid to go ahead and do that; even on the new bill they are afraid because of the court decisions and the rules of the Internal Revenue Service. And the Internal Revenue Service, Mr. Chairman, in our judgment is doing a very good job. We're for it. We think the underlying principles and what it is working toward are in the right direction. So, whatever I say now is not in any way derogatory to the Internal Revenue Service. On the other hand, it does point up the needs, as we have set out in our technical brief, of certain fundamental changes in regard to accumulated——

The CHAIRMAN. This is not an exercise of praise around here. I want your opinion on what you think is wrong with this bill.

Mr. MADDEN. We are giving it to you as we go along, the high spots. Of course, the brief is quite detailed.

Section 615 deals with exploration expenditures. Now, that has to do with the deduction of expenditures of not more than $75,000 and we think that limitation should be removed.

Of course, one of the most important points we bring out in our detailed brief is this matter of taxes coming from foreign sources.

The CHAIRMAN. Why do you think that $75,000 should be removed?

Mr. MADDEN. It is not enough. You have inflation right now.

The CHAIRMAN. How much do you want?

Mr. MADDEN. Whatever is legitimate to develop the mining industry ought to be permitted.

The CHAIRMAN. I am in hearty agreement with you but give me a clue.

Mr. MADDEN. I will give you a clue. We don't think there should be any. In other words, it is a legitimate expenditure for the development of mines. What that means from the standpoint of a high level of employment and a high level of production, is that the material being mined, of course, will be used. And we think that is good for the economy.

I want to stress that we feel the treatment provided for income from foreign sources is in the right direction. However, we don't think it goes quite far enough. We think that the definition of taxable income needs further study to make sure it doesn't take some of the benefits away. We are a little bit inclined to think that the old definition is sounder than the new one.

We fail to see why there should be any limitation on the types of business abroad that benefit from this. We think that the bill should extend to include all permanent bona fide establishments having employees directly engaged abroad in business activities, on a full-time basis. Take wholesaling as an illustration. Again that is helping our economy.

Then we come to direct individual tax benefits. Again, we think that H. R. 8300 is in the right direction, because we recognize the plight of the people in regard to inflation. It cannot repair the damages of inflation, but it can soften them. If we had the wherewithall there are many things we could do, but this is, we think, a step in the right direction. So we are for the particular objectives back of this bill. We think that the trend of tax rates, barring war, should continue to be definitely downward, and substantially so. We realize this depends upon Government spending being further reduced.

Now, the Chamber of Commerce believes that this is not only possible, but, collaterally, the Federal budget can be balanced. Accordingly, in the present period of economic readjustment, the chamber believes that personal income taxes are still much too high and should be reduced systematically in order that the taxpayers may retain more of their income. Part of this may well go to savings, and we hope some of it will find its way into equity securities.

In view of this, the chamber recommends that there be a flat 5 percent reduction in individual income-tax liability, to be effective on January 1, 1955, and that additional reductions be made thereafter in both personal and corporate rates of taxation as Government spending is progressively adjusted to peacetime conditions.

The CHAIRMAN. I don't need to point out to you that the flat-rate reductions are regarded as violating the principle of progressivity.

Mr. MADDEN. I am not too sure our tax committee agrees with that principle, the way it has been carried on and developed over the years.

The CHAIRMAN. I understand that.

Mr. MADDEN. I have an idea——

The CHAIRMAN. You think there is too much progressivity?

Mr. MADDEN. That is what we think. We have an idea a lot can be done along those lines, and should be done.

The CHAIRMAN. I am not quarreling with you. I just want to draw you out a little bit.

Mr. MADDEN. Now, going to the last part of my presentation which is very brief. This has to do with the constant propaganda we see in the papers about increasing personal exemptions.

The chamber is opposed to the proposal to increase the exemptions of individual taxpayers up to $1,000. Surely everyone should do his share, whether large or small, to bear the Nation's responsibilities through direct taxes. We believe that it is inequitable, as well as impractical, to transfer the income-tax responsibility of one class to another.

The CHAIRMAN. May I make one suggestion to you about that?

Mr. MADDEN. I wish you would.

The CHAIRMAN. This is a purely personal view. I don't want to weep and wail over taking somebody off the tax roll. In the 80th Congress I was the leader in the Senate on tax legislation that took 7 million people off, and I am very proud of it, and I would like to take 7 million more off, but that depends upon how we do it and when we do it.

The average fellow you are talking about spends about a third or a fourth of his income for taxes, one way or the other. People are paying lots of taxes, and they are conscious of it, too.

Mr. MADDEN. Now, in regard to that——

The CHAIRMAN. All I am trying to say is I don't break down into tears every time I think about somebody getting off the Federal tax rolls. I want to get people off, but I would like to see how it is done.

Mr. MADDEN. Why not have us all get off? That would be a good idea.

The CHAIRMAN. If you could run this Government without any taxes, that would be a wonderful way.

Mr. MADDEN. That would be fine.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Mr. MADDEN. Let me just finish up this one statement. The proposed increase in exemptions would cost about $8½ billion. The question arises: Where could we get the money for it? Certainly not from those paying taxes on annual incomes of over $10,000.

When Mr. Snyder was Secretary of the Treasury, he appeared before the Ways and Means Committee on the Revenue Act of 1951, and he said that if every penny of income over $10,000 were confiscated, only about $3,500,000,000 additional would be raised. Senator Williams, more recently, said in the papers that confiscation of everything over $10,000 would produce only $5,200,000,000.

So, again we ask: How would the Government replace this lost revenue? Where could this $8,500,000,000 come from, especially with the other losses the Government is going to have in the next several years, with normal developments.

The chief argument for this increase is greater consumption, and my reply to that is that right now our consumption is at the peak——

The CHAIRMAN. Is what?

Mr. MADDEN. Is at the peak. Last year it was at an all-time high, around $231 billion, according to the National Industrial Conference

Board. I understand that the Council of Economic Advisors was responsible for that figure. This year, the first quarter, it ran around $230 billion.

We feel that consumer purchasing power is still tremendously high. It is up to business to go out and sell the public on the value of its services—the money is there—instead of trying to get relief of this particular type.

The need right now, as we see it, is in the matter of helping to remove the inequities that this bill does, and also trying to help business to get on a solid economic basis so we can face the future which we think is mighty promising.

If the Congress decides to go along with the recommendations and decides to pass up this matter of personal exemptions, every dollar spent in the way of facilitating the development of business will have a multiplier effect. What that really means, Mr. Chairman, is that the money spent is for investment and also for payrolls and the demands for tools and equipment and so forth. Not only is it spent on tools and equipment and the like, but employees get it and they spend it too. So, it goes right down the line. It is used in a number of ways to develop our economy, and we think the people who developed H. R. 8300 had clearly in mind the needs of the country. We think also that their efforts to remove inequities have been consistently along the right lines.

The CHAIRMAN. I wish you would say some more about the exemption. You are opposed to that?

Mr. MADDEN. Yes, sir. Well, in the first place, we don't think that is the problem of the country right now. We think purchasing power right now is near the all-time high, and we think the argument that the exemption is necessary to stimulate consumption is unsound.

Now, there were times before when such action was justified but we don't think this is such a time. Furthermore, we think the need right now is along the lines of trying to get the tools and equipment to produce on a low-cost basis to meet foreign competition.

I was down in Jacksonville about 2 months ago, and I was amazed when I was told some English firms were shipping certain commodities over here—I don't happen to recollect what they were—and selling them here at a lower cost than we could even after paying for transportation.

We are anxious to maintain our high standard of living, and we can do it. But it is quite difficult to do so if you have one hand tied behind you because you haven't got the equity capital to come through the way you should.

The CHAIRMAN. What happens when you spread a lot of consumer money around? That isn't lost. It isn't operating in a vacuum. If you go to the grocery store and buy consumer goods, that trickles up. If you buy a can of beans or a few consumer items, somebody has to make the can, and pretty soon you are into heavy machinery. Why doesn't that fertilize the economy as well as perhaps some other expenditures?

Mr. MADDEN. Let me answer that by saying we followed the consumption theory of taxation pretty closely until World War II, and we didn't have full employment, and it took World War II to give us full employment in the United States.

So that this matter of consumption is not the sole answer. There are times when what you say is right, but we don't think this is the time.

The CHAIRMAN. What you are talking about is the balance——

Mr. MADDEN. That is exactly what you need. You need a coordinated balanced tax system, dependent upon the current needs of the country, plus the outlook of the country.

The CHAIRMAN. If the economy took a turn, that might be different.

Mr. MADDEN. It might be different.

The CHAIRMAN. You think in relation to everything else that consumer spending is at an all-time high?

Mr. MADDEN. At an all-time high, yes, sir.

You see, the problem of consumer spending is, the savings are there and it is up to business to go out and attract those savings into more radios and television sets and cars and things like that. If the public is holding onto its money a little tightly, all right; we have to be ingenious enough to go ahead and sell the public. Maybe the trouble is they have to retrain the sales force——

The CHAIRMAN. You have to retrain a lot of businessmen who have been used to easy Government contracts, also.

Mr. MADDEN. I think you are absolutely right on that.

The economic outlook of the United States is most promising. The population is growing at a monthly rate of 250,000 people. Now, this represents the population of a city the size of Omaha. To take advantage of this growth, sound long-range economic planning and good management is absolutely essential for our national welfare, and the character of taxation can't help but determine the ability of business to make appropriate contributions to our economic welfare.

H. R. 8300 represents a basically sound tax policy even though there are a number of amendments which we think should be adopted. The chamber endorses the fundamental principles of this bill, and it urges the Senate Finance Committee to report it favorably with technical amendments which have been submitted.

This bill creates a new tax structure. It sets forth certain guideposts which will strengthen our economy and help to maintain high levels of economic activity and employment, both now and in the future.

That concludes my presentation.

The CHAIRMAN. Thank you.

Mr. MADDEN. May I submit this for the record?

The CHAIRMAN. Yes, we will put it in the record.

Mr. MADDEN. And also the detailed memorandum.

I want to express my appreciation to you gentlemen for your courtesy this morning.

Senator WILLIAMS. I would like to ask Mr. Madden one question: I notice the chamber of commerce is endorsing the lower trend in taxes, and I think you advocated a 5 percent reduction for individual taxpayers.

Mr. MADDEN. That is right, to January 1.

Senator WILLIAMS. You, in general, endorse this bill, with the suggestion perhaps that it should go forward. And I also note you say that you think it should be dependent upon Government spending, but that Government spending can, in your opinion, be reduced and the budget can be collaterally balanced, which is the word you used.

Mr. MADDEN. Yes, sir.

Senator WILLIAMS. I wish you would go into that further and tell us how you think it could be balanced, absorbing these tax reductions, because that is the $64 question.

Mr. MADDEN. I might answer that in this way: Structurally, the United States Chamber of Commerce is broken down into divisions and committees, much the same as Congress is. We have a Government Expenditures Committee, a very fine body of men who are constantly working with the Government. That committee has presented the board of directors on various occasions a bill of particulars upon this problem. And it is upon the recommendation of the Government Expenditures Committee that this conclusion has been reached.

I am the chairman of the tax committee, and we have no direct relationship with Government expenditures.

Senator WILLIAMS. Would you supply for this committee those recommendations, in order that we can make them a part of the record, because I think you recognize they do go together and must be considered together.

Mr. MADDEN. Yes.

(The information requested follows:)

April 26, 1954.

Hon. JOHN J. WILLIAMS,
United States Senate Office Building,
Washington, D. C.

DEAR SENATOR WILLIAMS: Mr. James L. Madden has asked that the national chamber prepare a reply to your request of him on April 23 for further information regarding its policy on reduction of Federal expenditures.

The chamber believes that the Government's expenditures should be progressively reduced to permit further tax reductions and a balanced budget at the earliest practicable date.

To effect the substantial reductions in spending that permit further tax reductions, there of necessity will have to be fundamental changes in Government policy. Unless the Government's programs of services and activities are revised, expenditure savings by economies alone will not be adequate to permit the additional tax cuts that should be made.

Over the past two decades the Federal Government has adopted a vastly expanded program of activities. Some of these activities need to be continued. Others can be better and more economically handled by the States and municipalities. Still others are inappropriate undertakings for Government and should be left to private initiative.

The Federal Government's activities are now being critically examined by two Federal Commissions, on Organization of the Executive Branch of the Government and on Intergovernmental Relations. Their studies and recommendations should lay the basis for reconstituting and curtailing the Federal Government's operations. The chamber endorsed the establishment of these two Commissions and expects to support their recommendations.

Pending issuance of the reports of these Commissions, we suggest for consideration certain areas of Government expenditures and activity which we believe should be further examined by the Congress with a view to achieving a lower level of Government expenditure:

National defense.—In a recent letter to the House and Senate Appropriations Committees, the chamber endorsed the long-range military plans and programs embodied in the so-called New Look in defense as leading to a more effective defense program at less cost.

We believe that further savings in defense expenditures, particularly for maintenance and operations, would be made possible by more rapid effectuation by the armed services of the Business Management (Eberstadt) Amendments made in 1949 to title IV of the National Security Act. As Subcommittee No. 3 of the Senate Armed Services Committee recently said, "The potential elimination of avoidable waste is almost unimaginable" through effectuation of these amendments. As it also said, however, in referring to slow progress in putting these

amendments into operation, "* * * the record of the past 4 years is not a satisfactory one." Continued scrutiny by Congress of progress in this area will materially help to save large sums of money.

Foreign aid.—The chamber supports the underlying principle of foreign aid, both military and economic. We believe, however, that the proposed amount of the foreign economic aid program should be subject to closest scrutiny by those who are in a position to effect reduction.

Government competition.—Government competes with private enterprise in many important economic fields. In the armed services alone such activities aggregate approximately $10 billion annually. Curtailment of these activities—both military and civil—would mean substantial savings in production and procurement, in maintenance and operations, in personnel and in general overhead costs.

Social welfare.—Review the general program of public assistance, with a view to returning more responsibility to the States and to the people. This would save present Federal-aid and administrative costs, and at the same time permit more efficient and economical administration, with greater flexibility and adaptability to local needs. A similar review might be made of public-health grants.

Miscellaneous activities.—There are many specific activities the appropriations for which should have closer scrutiny, as for example, TVA and other public power programs; the appropriation for rivers, harbors, and flood control; various appropriations for the Department of Agriculture, particularly the increases recently made by the House above the recommendations of its Appropriations Committee and the Budget Bureau; and the programs of medical care for veterans for non-service-incurred disabilities.

Likewise, there should be review of many minor activities including miscellaneous appropriations for the Bureau of Reclamation in the Department of the Interior and the Forest Service in the Department of Agriculture. We object, moreover, to any portion of the appropriations for international labor organization purposes being used to support ILO industry committees, which we believe should be abolished as serving no useful purpose. Similarly we suggest that there be no appropriation for administration of the Walsh-Healy Public Contracts Act which represents unnecessary duplication with the functions of the Fair Labor Standards Act.

We firmly believe that if the Congress will reappraise Federal activities and services substantial reductions are possible in the level of Federal spending.

We recognize that this is not a task that can be accomplished overnight. Many changes will be required in the basic legislation establishing and providing for these various activities. However, congressional review and scrutiny now can lay the groundwork for implementing the recommendations of the Hoover and Intergovernmental Relations Commissions when they are submitted.

Support by the Senate of cuts made by the House in acting upon appropriations recommendations will serve as a basis for greater economies in years to come.

Cordially yours,

CLARENCE R. MILES.

Senator WILLIAMS. We are all in favor of extending tax reduction further, and we are all in favor of balancing the budget, but, as the chairman pointed out, we are looking for some method of doing that, and frankly thus far we haven't found it.

Mr. MADDEN. Are there any other questions? Thank you very much, gentlemen.

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

(The prepared material of Mr. Madden follows:)

TESTIMONY OF JAMES L. MADDEN FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

My name is James L. Madden. I appear here today to submit the views of the Chamber of Commerce of the United States on the proposed Internal Revenue Code of 1954.

The Chamber of Commerce of the United States heartily applauds efforts of the administration and the Congress to develop and maintain sound fiscal policies. As methods of Federal taxation have a direct bearing on these policies, the

chamber strongly endorses H. R. 8300, its basic philosophy and objectives with certain technical changes as being currently in the public interest. Accordingly, the chamber hopes that the Senate Finance Committee and the Senate will act favorably upon this bill to remove inequities.

CURRENT ECONOMIC CONDITIONS

The country is going through an economic adjustment from an inflated wartime economy to a more normal peacetime basis of operation. The adjustment seems to be taking place in an orderly manner and gives promise of stabilizing on a high level of peacetime production. The country is fundamentally strong. Gross national product was running at the annual rate of $359 billion in the first quarter of 1954, or a shrinkage of about 3½ percent from the peak second quarter of 1953. The level of employment between these two periods continues to be high, in fact, it is estimated that there were about 61,500,000 people employed in March of last year, or a shrinkage of about 5 percent since last year. The backlog of personal savings of the people, exclusive of holdings of corporate securities, at the end of last year, was at an all-time high of $380 billion, and there is good reason to suppose that there is a further increase this year. The foregoing encouraging picture of a national character, however, does not portray the lack of balance in important segments of the economy because it does not reveal the extent to which the success of some businesses offsets the difficulties of others.

Granting a strong basic economy, we must recognize the problems of economic adjustment to more normal peacetime levels by business generally, and particularly by those segments in our economy which are out of balance. Equally important is an appreciation of some of the overall weaknesses in our economy which could spell serious trouble in the future. High among these is the matter of inflation.

INFLATION AND TAXES

Inflation is certainly a major problem and one which our Federal tax policies can help to curtail by ceasing to sap the vitality of our business structure. How far we have gone along the road of inflation is seldom fully grasped by the man in the street. Taking construction and the production of durables for illustrative purposes, the National Industrial Conference Board tells us that the value of this construction at the end of 1953 amounted to the astounding sum of almost $25 billion. Yet the same amount of work could have been done for $10 billion, according to the Board, if the purchasing power of the 1939 dollar was available today.

Production is one of the key answers to inflation. It also provides jobs. The maintenance and stimulation of high levels of production and employment during the current period of economic adjustment is certainly in the public interest—and no one wants these high levels more than business. H. R. 8300 endeavors to remove some of the impediments imposed upon business during the days when taxes and their administration were too often used for purposes other than revenue. Unfortunately, the scope of the operations of the Federal Government and resultant demands for revenue have reached such great proportions that the Government is unable to do more, through H. R. 8300, than to take partial steps to help correct many inequities at this time.

PRODUCTION AND EQUITY CAPITAL

Capital, and particularly equity capital, plays an important role in creating new jobs and maintaining high standards of living. As industry becomes more and more competitive, its ability to operate on a low unit cost basis and to develop new products and services is directly related to the amount of new capital that can be secured. New capital helps make possible the purchase of new equipment, facilities, and structures and the replacement of old. Many firms have found the latter difficult during the immediate past because inflationary trends have made their depreciation reserves inadequate. Furthermore, the capital investment per worker has steadily increased over the years and in 1950 this was $10,000 in manufacturing interprises, according to the National Industrial Conference Board. Undoubtedly this figure is much higher today.

Corporate debt is now about $190 billion, double that at the end of World War II. The ratio between debt and new equity financing since the war has been $3.20 to $1. This spread is too high and reflects an unsound relation between new bond and stock investments. Investors seem to prefer the safety

of a bond yield of about 2½ percent on the average last year to the risk of equity investments. To attract equity capital, the law of supply and demand forced the yields on common stocks last year on the New York Stock Exchange up to 6.3 percent. This seems attractive until the Federal taxes are applied and then it becomes obvious why there have been relatively thin equity markets. The lack of substantial investing in new equity securities is also pointed up by the fact that on September 30, 1953, 62 percent of the stocks on the New York Stock Exchange were selling below their book value and 48 percent of all the stocks were selling at more than 20 percent below their book value.

Small and growing businesses with inadequate amounts of equity capital often do not have established credit to get funds for the expansion of their business through the issuance of bonds, nor can they always go to a bank for assistance in meeting their temporary needs. A number of big companies too have been having their difficulties in attracting adequate equity capital, but have solved their problems, in part, by increasing debt ratios and retaining more of their earnings than would normally be the case. The small firms frequently do not have these earnings to fall back on. In effect, companies in these categories are apt either not to progress, or tend toward topheavy debt structures which could cause serious difficulties when business declines.

As H. R. 8300 is designed to remove inequities, certainly there are a number which exist in the Federal tax law which are responsible to a substantial degree for the unsound relationship of debt capital to equity capital in many businesses. The Guaranty Trust Co. pointed this out in an advertisement, entitled "A Blind Spot in the Tax Debate," in the New York Times on April 19, 1954. After giving an illustration of the drastic discrimination against equity shareholders, it states:

"In the face of such figures as these, it is easy to understand why corporations have found it increasingly difficult to finance their capital needs by issuing stock and have been forced to withhold larger portions of their earnings from distribution and to meet their additional capital requirements by going into debt. In too many cases, it simply is not worth while for investors to take the risks involved in stock purchases for the sake of the meager returns obtainable. This is not the sort of tax structure that promotes the development of a strong, growing dynamic economy."

H. R. 8300 recognizes a number of the inequities in the tax law which retard the adjustment of business on a sound financial basis to new domestic and foreign competitive conditions and a buyer's market. While the chamber regrets that some steps have not been taken toward the ultimate elimination of the tax on capital gains, it appreciates the basic change in the tax philosophy of the bill which will provide some relief for business in the future, such as that dealing with depreciation and double taxation of dividends. The effect will be to allow business to retain more of their own earnings to meet new conditions and to give at least some encouragement to investors in equity securities.

H. R. 8300 PROMOTES ECONOMIC WELFARE

1. A businessman should build depreciation reserves so that he has on hand, after the useful life of a tool or equipment is completed, a sum necessary to replace it. Unfortunately, high taxes, administrative rulings by the Internal Revenue Bureau over the years and inflation have made this practically impossible for many concerns. As a result, many concerns have not been able to maintain adequate depreciation reserves out of their earnings. Estimates have been submitted to the Treasury which indicate that "with a realistic depreciation policy, our national industrial plant could produce an extra $7 billion worth of new equipment and junk some of the old." This would place many concerns in a stronger competitive position, but also help assure jobs for employees and help reduce prices.

The United States Chamber realizes only too well the necessity of realistic tax legislation and administrative methods on depreciation. It believes that the "full costs of depreciable property should be recoverable free of tax as rapidly as is reasonable and that the depreciation claimed by the taxpayer, in accordance with the computations used in his books of account, should be accepted unless clearly unreasonable." While H. R. 8300 does not go as far as the chamber thinks necessary, the declining balance method set forth in the bill is in the right direction and, in addition, the sympathetic understanding of the depreciation problems of business by the present Internal Revenue Service is much appreciated. The bill will enable many businesses to get some relief from the onerous conditions previously existing.

2. As indicated previously, another source of funds to help industry meet its capital needs for new tools and equipment is private investors. Certainly our tax laws have discouraged equity investments in business—in fact, they have thrown impediments in the way of investors. It is most encouraging to realize that at least a start is being made in H R. 8300 in the direction of correcting this situation. The double taxation of dividends now applied to corporate earnings is a definite inequity which, in the opinion of the chamber, should be eliminated. If it is sound national policy to encourage economic programs, then business must have a steady flow of new capital, and the more at this time, the better.

Money is certainly worthy of its hire and the returns should be in proportion to the risk. If jobs are dependent on business and business requires increasing amounts of capital, then it would seem logical in a capitalistic country such as ours to stop penalizing present investors, or discouraging potential investors by double taxation. Just to illustrate, the annual report for 1953 of the United States Steel Corp. gives a good illustration of the impact of double taxation upon investors. A particularly interesting excerpt from the annual report follows:

"In 1953 United States Steel, in order to have 41 cents of income had to pay 59 cents in Federal income taxes. In other words, out of each dollar potentially available for dividends, 59 cents went for income taxes. The remaining 41 cents, when paid out in dividends, was then subjected on the average as previously noted, to a personal income-tax dimunition of 21 percent, equivalent to 9 cents. This left a net of 32 cents out of the original dollar. By this process of double taxation the Government, therefore, claimed 68 cents of the potential dividend dollar."

How long can the Government expect the necessary flow of new capital to business—particularly equity capital—under these conditions? It is believed that the elimination of double taxation would lead to a greatly increased flow of capital to business—and this means jobs.

Testimony against the double taxation of dividends has given the impression that this provision is essentially one for helping the rich. Undoubtedly, the 200,000 or so Bell Telephone employees who now own, or are in the process of purchasing, shares in the American Telephone & Telegraph will be surprised to learn this, and likewise the 70,000 stockholders in that company who have only 1 share. Similarly, the thousands of employees in Sears, Roebuck who are stockholders in that company will be interested, and so will the 56 percent of the stockholders of the United States Steel Corp., whose average income is a little less than $2,800 annually.

The administration and the Congress, in the opinion of the chamber, is certainly moving in the right direction in giving limited relief from the inequities of the double taxation of dividends.

3. According to the March 1954 report of the Council of Economic Advisers, entitled "Economic Indicators," page 22, the Federal Government took about 54.6 percent of the corporate profits before taxes in 1953. It is understandable why, under the pressure of war, high taxes of this character were necessary for the national security. If, as the chamber believes, the "future" of our economy is being built in part "today," it is obvious that this percentage has to be drastically reduced if business is to have adequate funds to not only take care of the present adjustments to peacetime levels, but also to lay a base for even greater service to the public in the future than ever before.

Laying such a base will not be simple because last year Federal taxes took about 24 percent of our national income—a dangerously high percentage. H. R. 8300 recognizes the validity of this statement in a number of ways. For example, it encourages ingenuity by more realistic treatment of expenses dealing with research and development, and continues the 52-percent maximum corporate tax rate, imposed in connection with the war, only until April 1, 1955. The chamber feels strongly that this particular tax should expire at that time. This result is in line with the thinking of the chamber which believes that the normal corporate rate of taxation should be reduced on April 1, 1955, from 30 percent to 25 percent, the effect being to reduce to 47 percent the 52-percent maximum corporate surtax rate. In connection with this position, it should be noted that the underlying membership of the Chamber of Commerce of the United States consists primarily of small and medium-sized businesses.

SOME SUGGESTED AMENDMENTS

The basic philosophy of the bill H. R. 8300, from the standpoint of the broad economic welfare of our country, is definitely good. Furthermore, the efforts to soften or remove many of the inequities which have accumulated over the years are to be commended, and from the standpoint of our current and future economic development, the bill is built upon realistic principles. However, it would be amazing if a monumental undertaking of this technical character was above criticism in some respects. Accordingly, in a cooperative spirit, the chamber suggests certain revisions for the consideration of the Senate Finance Committee.

1. Having in mind the capital needs of many businesses, particularly equity capital, the chamber believes that the provision (sec. 6016) for acceleration of corporate tax payments is unsound. In fact, it may well force many businesses to borrow money and even impair the working capital of others. In addition, this particular provision is at cross purposes with other provisions of H. R. 8300. For example, it would tend to offset the efforts to liberalize depreciation allowances. Instead of permitting business to retain more of its earnings during this period of adjustment and planning for research and development and increased expansion and employment in the future, the effect is the same as an increase in tax rates for the next 5 years—during which time many may be hard pressed for capital. Furthermore, it makes corporate taxpayers "crystal-ball gazers" when estimating their profits for taxation purposes.

2. The depreciation provisions (sec. 167) permit increased recovery of costs in early years but do not go far enough. The chamber believes that the strait-jacket of bulletin F should be elminated and that management should be permitted to chose the period over which investments should be recovered.

Section 167 (e) provides that unless the life of an asset, as determined by the Secretary or his delegate, differs by more than 10 percent from the life used by the taxpayer, the taxpayer's depreciation rate is to prevail. The chamber would appreciate a statement from the Senate Finance Committee in its report to confirm the understanding that the 10-percent rule will not be applied on the basis of artificial bulletin F lives, but on the basis of reasonable lives in each case determined by the Secretary or his delegate. In other words, it asks the committee to assure taxpayers that the 10-percent rule, which was meant to be helpful, will not become an outright invitation to revenue agents to measure the useful lives of depreciable property taken by taxpayers against the arbitrary standard of bulletin F. The Secretary or his delegate should also make this clear in the regulations interpreting the statute.

3. The chamber has a number of other sugestions which are incorporated in a brief which is hereby submitted for the information of the committee. Among the more important ones are:

A. Sections 243 to 246 which deal with dividends received by corporations. These sections allow corporations an 85-percent credit for dividends received from domestic corporations but exclude dividends from stock insurance companies. These companies are fully taxed and it is inequitable to discriminate against their stockholders.

B. Section 359. This deals with definitions relating to corporate organizations, acquisitions, and separations and provides unnecessarily strict rules governing the relative size of corporations which may enter into tax-free mergers and consolidations. It is believed that section 359 (a) discriminates against small corporations and in favor of so-called publicly held corporations.

C. Section 531 to 536. These sections, which relate to the accumulated earnings tax, propose to change the existing law by shifting the burden of proof in certain cases to the Commissioner and by permitting a dividends-paid deduction for accumulated taxable income where dividends are paid on or before the 15th day of the 3d month following the close of the taxable year. These provisions are in line with chamber recommendations but still leave some inequities.

As a few illustrations, it is believed that section 535 should be amended to permit as a deduction in computing accumulated taxable income an amount equal to the portion of the corporation's earnings which are retained for reasonable business needs. In addition, sections 531 to 536 should also be amended to make clear that the tax on the accumulated earnings should not be imposed where a corporation has used capital to enter a new field of activity or has invested in assets of an operating company unrelated to its business.

Every day we see examples of changes in consumer demand, a shifting of activity from one part of the country to another, and the emergence of new products resulting from advances in industry. In some cases corporations los-

ing business must be prepared to diversify their activities or shift to entirely new products. A corporation now takes a substantial risk in accumulating earnings to finance a shift in business, however, in view of certain court decisions and the position taken by the revenue service in some cases.

The chamber recommends that sections 531 through 536 be amended to permit management to change operations or undertake new ventures with freedom from fear of penalty taxes.

D. Section 391 deals with the effective date of provisions covering corporate organizations and adjustments. This section makes the organization and adjustment provisions effective with respect to distributions or transfers after March 1, 1954, with two minor exceptions.

Fair and reasonable provision must be made as to the effective date of sections 301 to 391. We suggest the March 1, 1954, effective date be retained, so that taxpayers are not deprived of the immediate benefits of the new bill, but also that the provisions of the Internal Revenue Code of 1939 shall be applicable to distributions or transfers occuring after March 1, 1954, and before January 1, 1955, if no gain or loss would be recognized as to such distributions or transfers under the provisions of the Internal Revenue Code of 1939, but would be recognized under the provisions of the new bill.

As you know, many taxpayers have tried to proceed with normal adjustments and readjustments of business enterprises during this transitional period, relying on the bill and on the statements in the press releases of the House Ways and Means Committee and Chairman Reed. These businessmen should be protected by retention of the March 1, 1954, effective date. At the same time, other taxpayers should be protected against retroactive application of the corporate adjustment and distribution sections in situations where this would be detrimental.

E. Section 615 deals with exploration expenditures. This contiues the deduction for these expenditures with the limitation of not more than $75,000 per year for 4 years. While this is a somewhat helpful deduction, it places drastic restrictions upon a strong mining industry with ample reserves for future development. As this development plays an important part in our economic life and encourages directly and indirectly high levels of employment, it would seem that the limitations should be removed.

F. Sections 923 to 951. These sections revise and liberalize the provisions on taxing business income from foreign sources. The chamber has submitted extensive memoranda to the House Ways and Means Committee on taxation of income from foreign sources, and some of its recommendations have been included in H. R. 8300. Unfortunately, the bill also contains provisions which will discourage rather than stimulate investments by United States citizens abroad.

Just to illustrate, sections 923 and 951 of the bill provide credits and elections to defer income for United States citizens investing abroad, exclude many companies with bona fide branch offices abroad and do not benefit the great bulk of American foreign source income. "Trade or business" in sections 923 and 951 should be defined so as to include "all permanent bona fide establishments having employees directly engaged abroad in business activities on a full-time basis."

G. Section 105. The concept of a qualified health plan which is outlined in section 105 is totally new and seems generally to be a desirable development. However, the concept would appear to be almost unworkable in the absence of more realistic tests for discrimination and other amendments to express clearly what appears to be the intent of the section. As regards the nondiscriminatory tests, this section at present requires use of the tests outlined in section 501 (e) which were developed for use with pension plans and are not adaptable for use with health plans. Other needed clarifications which we believe are in accord with the intent of this section are:

(*a*) Substitution of the phrase "contributions or payments" for the word "contributions" when referring to amounts paid by an employer in order to make clear that a special fund is not required.

(*b*) Development of a more flexible requirement for integrating benefits required by a State law with benefits under a health plan, inasmuch as State laws vary as between States, but also may require a different benefit both as to maximum amount and as related to earnings, for an occupational injury and for an off-the-job injury.

H. Section 501 (e). This section should provide explicitly that stock bonus, pension or profit-sharing plans already in effect on a qualified basis may continue without change and will receive the same treatment which the new law gives to a plan qualified in the future thereunder.

It should permit the establishment of plans under which eligibility is determined in accordance with statutory classifications of a broad nature without any requirement of meeting a numerical test concerning coverage of key employees. The types of benefits permitted should be broadened to permit greater flexibility in order that plans may be designed by employers to meet their own requirements. In order that there can be time for further development of additional statutory provisions for plans not expressly permitted by this statute it is suggested that the Secretary be given the authority for a limited period not exceeding 1 year to approve plans which he finds, in fact, do not discriminate in favor of officers, stockholders, supervisory, or highly compensated employees anything in the statute to the contrary notwithstanding.

DIRECT INDIVIDUAL TAX BENEFITS

The "forgotten men" during the growth of inflation have been retired people, widows and orphans, people who are sick, and those living on fixed incomes. Inflationary policies have also had their impact upon the homes and, as a result, many wives have had to go to work to help keep their families together. H. R. 8300 recognizes the plight of these people and while it cannot repair the damages of inflation, it endeavors to soften them. The chamber heartily endorses these provisions and hopes that Federal taxes, and other policies, shall be of a character in the future that much of the value of the dollar will be regained by definitely eliminating inflationary possibilities. This involves, among other things, further substantial reductions in spending.

In the opinion of the chamber, the trend of tax rates, barring war, should be definitely downward, but this depends upon Government spending being further reduced. The chamber believes that this is not only possible but that, collaterally, the Federal budget can be balanced. Accordingly, in the present period of economic readjustment, the chamber believes that personal income taxes are still much too high and should be reduced systematically in order that taxpayers may retain more of their income. Part of this will go to savings and it is hoped that some will find its way into equity securities. In view of this the chamber recommends that there be a flat 5-percent reduction in individual income liability effective on January 1, 1955, and that additional reductions be made thereafter in both personal and corporate rates of taxation as Government spending is progressively adjusted to peacetime conditions.

PROPOSED INCREASE IN PERSONAL EXEMPTIONS

The chamber is opposed to the proposal to increase the exemptions of individual taxpayers up to $1,000. Surely everyone should do his share, whether large or small, to bear the Nation's responsibilities through direct taxes and, further, it is inequitable, as well as impractical, to transfer the income-tax responsibility of one class to another. As the proposed increase in exemptions would cost about $8,500 million in lost revenue, the question arises as to who is going to make this loss up. Certainly not those paying tax on incomes over $10,000.

When Mr. Snyder was Secretary of the Treasury he testified, during hearings before the Ways and Means Committee on the Revenue Act of 1951, that if every penny of income over $10,000 were confiscated only about $3,500 million additional would be raised. Senator Williams, according to the press, recently had an estimate from the Treasury that the confiscation of everything over $10,000 would produce only $5,200 million. This assumes that people will continue to work to produce income which will be confiscated. So again we ask, "How is the Government going to replace this lost revenue from raising exemptions?"

Proponents of the higher exemptions argued that there can be no greater stimulant to reversing the present economic trends and stimulating the economy to continue growth than to increase individual income tax exemptions. Now, let us look at the facts. According to the Council of Economic Advisers, the total consumption in the first quarter of 1953 was at an annual rate of about $228 billion. The peak in consumption was in the third quarter of 1953 when this amounted to $231 billion. In the first quarter of 1954, the corresponding figure was $230 billion, or only a shade less than the peak of 1953. It is clear that consumer purchasing power is still extremely high, even though some segments of our economic structure are having difficulty in adjusting to competitive peacetime operations.

In support of the increase of personal exemptions, proponents further argue that tax reductions are a means of helping to avert a business downturn by re-

leasing additional purchasing power. It is a far cry from this to the proposal to strike several million people from the tax rolls because of increased exemptions.

The chamber urges a coordinated tax program which is designed to provide necessary revenue for essential Government operations, but one also which is in tune with the needs of our economy. The administration and the House of Representatives, in H. R. 8300, have properly sensed the pressing individual and business inequities which needed attention. In connection with the latter, every dollar of business earnings which can be left in the hands of business will have a multiplier effect on investments, payrolls, and demand for goods and services. This is where the greatest need exists today. The multiplier effect of these dollars will also come from the purchase of new tools, equipment, and structures so that American businesses might compete more effectively on the domestic and foreign levels, and also help maintain high levels of employment.

CONCLUSION

The economic outlook of the United States is most promising. The population is growing at a monthly rate of about 250,000 people, which represents the population of the city of Omaha. To take advantage of this growth, sound economic planning is essential, and the character of taxation will help determine the ability of business to make appropriate contributions to the future prosperity of our country.

H. R. 8300 represents a basically sound tax policy even though there are a number of amendments which should be adopted. The chamber endorses the underlying principles of this bill and urges the Senate Finance Committee to report the bill favorably with the suggested technical changes. It creates a new tax structure and sets forth certain guideposts which will strengthen our economy for the purpose of helping to maintain high levels of economic activity and employment, both now and in the future.

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES ON H. R. 8300, INTERNAL REVENUE CODE OF 1954

The chamber of commerce appreciates the opportunity granted it by the Senate Finance Committee to file a written statement in support of the recommendations presented orally by Mr. James L. Madden, chairman of the chamber's committee on taxation, on April 23, 1954.

We wish to commend the members of the House Ways and Means Committee and its staff, as well as the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department who produced the fine work in H. R. 8300. We also recognize the monumental task assigned to the Senate Finance Committee to revise and report out this bill to the Senate as quickly as possible, and we hope this statement will be helpful in the committee's consideration of our recommendations. We wish to make it clear that the chamber strongly supports the passage of H. R. 8300 with the changes and revisions noted in this statement.

SECTIONS 34 AND 116—DIVIDENDS RECEIVED CREDIT AND PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS

Sections 34 and 116 of the bill will help to alleviate the double taxation of corporate earnings, but they do not go far enough. The chamber has consistently advocated the complete elimination of this double tax inequity without resort to an undistributed profits tax. The Senate Finance Committee could eliminate the double tax entirely by granting a dividend-received credit to individuals in amounts equal to the tax paid upon those earnings by the corporation.

The unfairness of multiple taxation is now recognized in many sections of the 1939 Internal Revenue Code and the new bill:

(1) Estates, trusts and beneficiaries pay only one set of taxes on income;

(2) Partnerships, as such, pay no income tax;

(3) Corporations receiving dividend income receive a credit of 85 percent; and the President has recommended it be increased to 100 percent; and

(4) Credits are granted for foreign income taxes paid.

In addition, tax treaties have had as a major objective the elimination of double taxation of the same income. Dividends received by individuals should be free from double taxation just as other forms of income.

The problem of double taxation has been raised in other countries where income taxes have been adopted, such as Canada and Great Britain. In Canada an individual receives a deduction for dividend income under section 35 of the Canadian Income Tax Act for about 20 percent of his dividend income.

In Great Britain, the individual reports the full dividend, receives a tax credit for the amount withheld by the corporation, and the corporation receives credit on its tax on the amount withheld. This has the effect of imposing only one tax on the corporate income distributed.

The Ways and Means Committee in House Report 1337 summarized the effects of double taxation on dividends as follows:

"This results in a higher tax burden on distributed corporate earnings than other forms of income. In addition, this has contributed to the impairment of investment incentives. Capital which otherwise would be invested in stocks is driven into channels which involve less risks in order to escape the penalty of double taxation. This has restricted the ability of companies to raise equity capital through stock issues and has forced them to rely more heavily on borrowed money than is desirable either for the economy or for the firm. This is evidenced by the fact that debt financing has accounted for a high production of the total new financing. The penalty on equity financing has been especially harmful to small business which cannot easily borrow funds and must rely on equity capital for growth and survival" (pp. 5, 6).

The dividends received credit and the exclusion provided by sections 34 and 116 should be increased to prevent taxpayers from turning away from equity capital investments. The minimum credits in section 34 and the small exclusions in section 116 should be increased to eliminate entirely the double tax on corporate earnings. In addition, section 34 (c) (1) and section 116 (b) should be amended to allow the credit and exclusion to individual stockholders of capital stock insurance companies which pay the full corporate normal tax and surtax under existing law. This point is discussed in further detail in this memorandum under sections 246 (a) (1), 923 (d) (2), and 951 (c) (4).

SECTIONS 34 (c) (1), 116 (b), AND 246 (a) (1)—DIVIDENDS OF STOCK INSURANCE COMPANIES

Sections 34 (c) (1), 116 (b), and 246 (a) (1) of the bill would deny stockholders of stock insurance companies the newly establishesd relief for individuals from the double taxation of dividends and the 85 percent dividends received deduction for intercorporate dividends. The latter provision would also apply to intercorporate dividends received by an insurance company from its subsidiary insurance company. This is a major departure from present law which treats dividends of stock insurance companies in the same manner as those of other corporations and allows the dividends received credit in full for such dividends.

The new provisions are applicable both to stock casualty, fire, and other insurance companies now taxable under section 204 of the Internal Revenue Code of 1939 and to stock companies taxable under section 201 of the 1939 code, issuing life insurance and annuity contracts and noncancellable contracts of health and accident insurance. Clearly, there is no justifiable basis for this discrimination against casualty, fire, and other insurance companies taxed under section 204 of the 1939 code, nor does the committee report in any way explain this action. Under both the Internal Revenue Code of 1939 and the bill, these companies are taxed in precisely the same manner and at the same rates as other corporations. It is believed that this provision must have been incorporated in the bill through technical oversight, not through any desire to place the stockholders of these companies at a disadvantage or to make it more difficult for these companies to own subsidiaries.

Stock life and other insurance companies taxable under section 201 of the 1939 code are necessarily taxed on a basis different from other corporations. The unique nature of the business of these corporations has been recognized in the income tax laws since at least 1921. The various formulas which have been employed in taxing these corporations have each been designed to tax them on approximately the same basis as other corporations after giving proper recognition to the problems of determining the income of life underwriters.

These organizations are not exempt from tax nor are they allowed a dividends-paid deduction. As in the case of other corporations, dividends received by their stockholders have been subject to tax as earnings of the corporation. The urgent necessity of reducing double taxation on the income of corporations is just as

apparent in the case of stock life and other insurance companies taxed under section 201 where a special method of taxation is employed because of the peculiarity of the business as in the case of conventional corporations.

Insurance is a vital factor in the economic life of our country. It is imperative that the growth of companies writing insurance keep pace with the growth of our economy. The continued expansion of stock insurance companies depends in large part on their ability to attract new capital. The proposed discrimination against these companies would make their stocks unattractive as investments, greatly reduce their strength, and result in substantial loss to their present shareholders.

Treatment of foreign income of insurance companies

Under sections 923 and 951 of H. R. 8300, all insurance companies are denied the benefit of the 14 -point-tax differential on foreign income and the right to defer foreign income in certain cases.

The House committee report gives no reason for this discriminatory treatment and it is difficult to see on what basis such a distinction could be made. These companies clearly should be allowed the same tax benefits for engaging in foreign business as are allowed other corporations. Sections 923 and 951 of the bill were proposed to encourage American industry in the conduct of foreign business. Such incentives should be available to insurance companies as well as to other companies.

SECTION 101. EXCLUSIONS FROM GROSS INCOME—CERTAIN DEATH BENEFITS

At present a payment of a death benefit by an employer to beneficiaries of a deceased employee is excluded from income up to an amount of $5,000 if the employer is under a contractual obligation to make the payment. Where the payment is made from a qualified pension or profit-sharing plan, the exclusion does not apply if the employee has a vested right to receive the amounts while living.

This has been changed in the proposed bill. The exclusion would now apply to death-benefit payments from a qualified profit-sharing trust regardless of whether the employee's rights were vested or forfeitable. The bill also extends the exclusion to death benefits, whether or not paid under a contract of the employer.

The chamber endorses this action, particularly the elimination of the requirement that the benefits must be paid under a contractual obligation. However, the proposed bill now makes an inequitable distinction between pension and profit-sharing plans because the exclusion does not apply to death benefits paid from a pension plan where the employee has a vested right to the benefits.

The chamber recommends that section 101 (b) (2) (B) of the bill be changed so that the exclusion from income applies to death benefits paid from a qualified pension plan as well as from a profit-sharing or stock-bonus trust. The exclusion would apply regardless of whether the employee had a forfeitable or nonforfeitable interest in the benefits while living.

SECTION 104—COMPENSATION FOR INJURIES OR SICKNESS

Under present law amounts received as workmen's compensation, damages for personal injuries, and benefits from accident and health insurance policies, are excluded from income. The bill provides the same treatment for these items, but contains a limitation as to the amount of payments received through accident and health insurance.

If the employee pays the premiums on accident or health policy, the benefits will be exempt under the bill. However, different treatment is provided if the employer pays the premiums. In that event, the benefits under the policy will be taxable to the employee to the extent that they are attributable to the premiums paid by the employer unless they are excludable from income under the provisions of section 105.

The effect of such a provision is to penalize the employee who is injured. It would seem that a man who is injured and is in real need of funds should not be taxed on such funds which come into his hands through insurance. The problem is aggravated to an even greater extent by the fact that a man who has a severe injury will be taxed at higher rates than one with a lesser injury. This is true because the more severe the injury is, the greater benefits the employee will receive. Thus, he will be thrust into a higher income-tax bracket, and a greater portion of his benefits will be taxed away.

Because of these factors, it is the chamber's recommendation that such insured benefits remain tax free as they are under present law.

If this recommendation is not adopted, the Congress should provide some method for reducing the amount of tax which would be payable by the injured employee. This could be done by spreading the income over a 3-year period, taxing the benefits as long-term capital gains, or excluding from the employee's income some set amount such as $5,000. A provision such as this would be preferable to the provisions of section 104, since the employee would be relieved of the burden of paying tax at high rates simply because his injury was severe enough to allow him to receive greater benefits.

SECTION 105—QUALIFIED EMPLOYER'S ACCIDENT AND HEALTH PLANS

Under present rulings, employers' contributions to accident and health-benefit plans for their employees are deductible as business expenses and, if payments are made under an insurance-company contract, are excludable from gross income. The proposed bill would exclude from gross income amounts received under a qualified accident and health plan where such a plan meets certain objective tests. We assume that the proposal does not intend that a plan need be filed or qualified in advance, but rather is automatically qualified as long as the employer can demonstrate his plan meets the tests set forth in the bill.

Under the proposed bill a qualified accident and health plan would be required to meet some of the same tests required of a pension plan (sec. 501 (e)). Unfortunately, pension plans and health plans are not similar in character and it seems undesirable to attempt to test health plans with criteria developed for pension plans. This becomes self-evident in considering the relationship between an employer's contributions and benefits under a pension and a health plan. With a pension plan it is quite possible to require that an employer's contributions not be used to purchase a greater unit of benefit for one employee than for any other employee earning a lower salary. A comparable situation does not exist under a health plan. The cost of a doctor's bill varies with the nature of the disability and not just the salary earned by the patient. We assume the actual intent of section 105 was to prevent discrimination in favor of higher-paid employees. Accordingly, it is understandable that the plan should be required to make available substantially comparable benefits to all employees. However, no useful purpose seems to be served by requiring contributions to a plan to meet nondiscriminatory tests. Proper safeguards can be applied more realistically in testing the availability of comparable benefits to all employees. In any event, if there is to be a requirement that the burdensome administrative tests of equating contributions be undertaken, then we strongly urge this section be clarified to assure that only the employee's contribution, if any, is required to meet special tests.

Also, the plan should not be considered discriminatory merely because the amount or duration of benefits (with particular reference to loss of earnings) under the plan varies in accordance with length of service or the age of the employee.

Regarding the payment of benefits for loss of earnings, we assume the proposed bill does not intend to require the employer's contributions be paid into a fund, because no useful purpose would be served by this device. However, some of the phraseology of the proposed section is not clear. Section 105 (c) (1) (C) (ii) refers to "contributions to the plan." Needless confusion could be eliminated if this section were amended to read "contributions or payments under a plan."

Section 105 (c) (1) (D) requires that a plan providing for compensation for loss of wages during sickness must allow for a waiting period. It is the customary practice of many companies to continue regular pay to employees without a waiting period. To exclude payments made during the first few days from the $100 weekly exemption would be extremely difficult to justify to employees in the case of such a long-established custom.

If this waiting period requirement is not removed from the statute, section 105 should be reworded so as not to require an amendment to plans presently in existence. Generally speaking, the amendment of such plans would create a serious administrative problem and possibly a problem of employee morale. In any event, a serious contractual problem would be created under negotiated plans.

The committee also suggests that the nondiscriminatory tests of the new bill be clarified regarding programs where State laws contain provisions requiring

the payment of benefits which are within the scope of health plans. Benefits required by law may or may not be integrated with the qualified plan. Also, the plan may provide benefits of one amount for an occupational injury and benefits of a different amount for an off-the-job injury. Accordingly, a plan should not be considered discriminatory merely because it provides different rates of benefits for different causes of injury or sickness.

In order to simplify the integration of benefits required by State law and benefits under a qualified health plan, we suggest that the first sentence on page 25 of the bill presently stating "or the District of Columbia requires employers to make payments into a fund, such fund shall be treated as a plan of an employer for the exclusive benefit of his employees," be amended to read "or the District of Columbia requires payments into a fund, such a fund shall be treated as a plan or part of a plan of an employer for the exclusive benefit of his employees."

Finally, we wish to call to the attention of the committee that the employer will face practical problems in determining the proper sum to withhold from amounts paid to employees where an accident and health plan is involved under the new law. Unless the employer has some freedom to estimate withholding amounts and to make retroactive adjustments, it may be necessary to delay payment of wages or benefits.

SECTION 167. DEPRECIATION

Section 167 of the bill should provide, for new property constructed or acquired after December 31, 1953, depreciation allowances more realistic than those permitted for new property in prior years. The chamber has serious doubts, however, whether the section will accomplish the liberalization necessary, and believed intended, even for new property, and doubts as to whether the section, unless amended, will assure reasonable administration.

As many of the committee members know, the position of the chamber has been that arbitrary standards of useful life, such as Bulletin F and historical studies used by revenue agents in the past, will not produce realistic allowances. Those charged with business management, their financial advisers and auditors, rather than the Internal Revenue Service, should determine the period over which depreciation should be taken. They are in the best position to know what investments should be made and the useful life over which these investments should be recovered and of income produced by the investments.

The chamber's policy statements with respect to depreciation are as follows:

"Full costs of depreciable property should be recoverable free of tax as rapidly as is reasonable; the depreciation claimed by the taxpayer, in accordance with the computations used in his books of account, should be accepted unless clearly unreasonable. The 'tax benefit rule' should be applied to adjustments of the tax basis of property on account of depreciation and depletion.

"Possible methods of giving suitable recognition to increased costs of replacements should be considered."

If an intermediate plan for measuring depreciation must be used until taxpayers can be permitted allowances in accordance with their books of account, it is still necessary that the intermediate plan be workable. We believe there is serious doubt that section 167 of the bill will put a stop to past controversies and will assure more appropriate allowances for new property. Much will depend on how the section is administered. There is indication in the technical discussion in the report of the House Committee on Ways and Means that the new section might just shift the area of controversy between taxpayers and revenue agents. Our doubts as to section 167 will be demonstrated by the following questions and comments:

1. Subsection (a) of section 167 permits a "reasonable allowance" for the exhaustion, wear and tear of property. Subsection (b) specifies that after December 31, 1953, the term "reasonable allowance" shall include (but shall not be limited to) an allowance computed in accordance with the methods set out in the subsection. Does this mean that a taxpayer is entitled, as a matter of right, to use one of these methods for new property, assuming he uses an accurate "useful life"? Or must that taxpayer defend each computation and, for example, prove that declining balance depreciation at 200 percent of the straight line allowance is not unreasonable? The detailed discussion of the technical provisions of the bill included in the report of the Committee on Ways and Means at pages A48 to A53 states that the subsection (b) provides only a "presumption" of reasonableness if a taxpayer uses one of the statutory methods. Clearly, if the taxpayer has the right to use the method, as he should, the tech-

nical discussion in the report of the Committee on Ways and Means must be re-examined by this Committee and rejected because it is couched entirely in terms of presumptions. The word "presumption" carries with it the implication that the presumption can be rebutted. Since the legislative history of the bill will carry great weight in litigated cases, it is essential that the technical discussion conform to congressional intention.

If, on the other hand, a taxpayer, despite the language of subsection (b), is not entitled as a matter of right to use one of the designated methods for new property, assuming a proper useful life, then it is apparent that the subsection will be of no assistance to taxpayers. A revenue agent could take the position that a statutory method permitted more depreciation than he wished to allow and the taxpayer would be required to submit or incur the expense of resisting the agent's contention. It is of vital importance that the new section get off on the right foot with an unambiguous legislative history.

2. Subsection (b) also indicates that a "reasonable allowance" shall not be limited to an allowance computed in accordance with paragraphs (1), (2) and (3) of the subsection. The report of the House Committee on Ways and Means, at page 23, emphasizes this by saying:

"The provisions of the bill are not intended to preclude a taxpayer from basing his depreciation rates on circumstances and facts which necessitate a more rapid writeoff than will be permitted under the declining balance method."

Yet, in contrast with this, the discussion of the technical provisions of the bill, at page A48 of that report, referring to the declining balance method in paragraph (2) of subsection (b), states:

"The rate to be used under this paragraph may never exceed twice the rate which would have been used had the deduction been computed under the method described in paragraph (1)." (Straight line)

This ambiguity leaves considerable doubt as to what is intended to be permitted under subsection (b). If a more rapid rate of depreciation is to be permitted under certain circumstances than 200 percent declining balance depreciation, this should be made clear in the report of this committee. Otherwise administrative officials will read the limited language in the technical discussion in the report of the House Committee on Ways and Means as a mandate for a narrow application of section 167.

3. We believe it most important that depreciation allowances for property constructed or acquired prior to December 31, 1953, even though not permitted at the higher statutory rates, be computed in a realistic manner and not restricted to the computation of prior years. Endless arguments with revenue agents year after year have resulted in completely unrealistic useful lives upon which depreciation allowances are now computed. Companies have lowered their rates rather than spend endless hours arguing. This situation can and should be corrected at the present time.

We appreciate that subsection (e) of section 167, initiating a 10-percent rule, was designed to cover property constructed or acquired prior to December 31, 1953, as well as to property constructed or acquired thereafter. However, experience in measuring depreciation by present Internal Revenue Service standards of determining useful life, such as bulletin F and historical studies reflecting experience of depression and pre-World War II years, has been so unfavorable that we are most concerned that the 10-percent rule will be a device to harass taxpayers rather than help them. As will be obvious to the committee members, if the administration of depreciation allowances is on a restricted basis, a revenue agent can readily contend that a correct "useful life" is more than 10 percent more than that used by a taxpayer.

There is no assurance in subsection (e) that a revenue agent will not simply claim a spread greater than 10 percent and we believe that this committee should see that this will not be done.

There are several methods which might be used to do this. The first is that the report of this committee can make it entirely clear that the 10-percent figure is set at a minimum so that administrative officials will not constantly urge the reduction of depreciation rates and that it is not the committee's intention that the percentage be read as a mandate to question all allowances. Secondly, the committee might replace the 10-percent rule with a rule similar to that included in Revenue Ruling 90, Internal Revenue Bulletin 11, May 25, 1953, issued by the present Commissioner of Internal Revenue. This provided that revenue employees should propose adjustments in current depreciation deduction only:

"* * * where there is a clear and convincing basis for change."

This rule is discussed in the report of the Committee on Ways and Means at pages 24 and 25, where it is stated that the new 10-percent rule was in no way intended to replace the "clear and convincing basis" rule.

The merit of replacing the 10-percent rule with the "clear and convincing basis" rule can be seen from the discussion of the technical provisions of the bill in the report of the Committee on Ways and Means. At page A52 an example of the 10-percent rule is given with the statement that where the difference is more than 10 percent:

"* * * the secretary *will* initiate action to adjust the depreciation rate." (Italic supplied.)

This appears to be inconsistent with the earlier discussion in the committee report at pages 22 to 25 and clearly emphasizes the need for clarity on this matter.

4. Another matter that requires clarification is whether paragraph (3) of subsection (b) of section 167, providing for other consistent methods of depreciation, is applicable at the taxpayer's election as a statutory right or whether the right is subject to the consent of the Commissioner of Internal Revenue. For example, it is quite possible that a taxpayer starting January 1, 1954, on a straight-line method of depreciation would later wish to compute depreciation under paragraph (3) in a manner so that the total allowances would not exceed that permitted by declining-balance depreciation. Is this taxpayer to be permitted to do this without the Commissioner's consent? If the Commissioner is to have the discretion to deny the use of another method in such case, the entire new section is subject to administrative limitation. As the committee knows, discretion on the part of Revenue Service officials in the past has been broad but the administration of depreciation has been most unsatisfactory.

Our concern on this score is illustrated by the discussion of the technical provisions of the bill at page A50 of the report of the House Committee on Ways and Means. Here it is provided that:

"In order for a taxpayer to use these methods (subsection (b)) he need only compute depreciation thereunder for the first taxable year ending after December 31, 1953, in which property described in subsection (c) is acquired."

This discussion continues by providing:

"In the case of unit accounts, any reasonable method may be selected for each item of property but must be applied consistently to that item. In the case of group, classified or composite accounts, any reasonable method may be selected for each item of property and must be applied to that account consistently thereafter."

As is apparent from this, unless the matter is clarified by this committee, the new statutory methods might become "one shot" affairs. A taxpayer selecting one method after December 31, 1953, could not change that method to another statutory method without the consent of the Commissioner. If this be the case, then the only effect of subsection (b) might be to give all taxpayers one new election as to depreciation of new property. As the committee knows, the Commissioner of Internal Revenue in the past has had full authority to permit declining balance depreciation, for example, but has done so only occasionally. It is most important that the new bill permit taxpayers more freedom than they have had in the past.

CONCLUSION

The chamber of commerce recommends and has recommended previously that the revenue laws permit taxpayers to recover the full cost of depreciable property as rapidly as is reasonable, and that the depreciation deductions claimed by a taxpayer, if in accordance with the computations used in his books of account, be accepted unless clearly unreasonable. Taxpayers should not be required to adhere to depreciation allowances used in prior years if those allowances were merely compromises with revenue agents or were set too conservatively in order to avoid controversy with the Revenue Service.

Until the committee believes that taxpayers can be afforded the right to make their own determinations, the chamber commends the new depreciation section in the revenue bill as a step in the right direction. We urge most strongly, however, that the report of the committee make it clear that it does not intend a narrow or restrictive interpretation or application of the section and views the methods of computation outlined in subsection (b) of section 167 as matters of statutory right and not just as methods available only at the discretion of the Internal Revenue Service.

SECTIONS 301-391—CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Perhaps the most sweeping and significant changes effected by the proposed Internal Revenue Code of 1954 are in the field of corporate distributions, liquidations and reorganizations. The proposed changes, judging by their scope and complexity, reflect a tremendous amount of careful and considered study and effort on the part of all of those contributing to the new provisions.

The chamber wishes to commend those responsible for the proposed new revisions. We feel the general product of these efforts will mean a great improvement in this corporate area of taxation. To be helpful to your committee, however, we would like to point out a few places in the proposed changes which seem to us to require correction.

Sections 302 and 309: The combined effect of these two sections will be to tax at rates much higher than those applicable to capital gains, distributions which cannot fairly be said to be essentially equivalent to a taxable dividend. It is true there are very narrow exceptions to the operation of this new general rule engrafted in section 302. These exceptions, however, are totally inadequate to cover the groups of cases in which the distributions cannot be said to represent taxable dividends.

The abuse of the distributions in partial liquidation procedure in an effort to circumvent the taxation of distributions as ordinary dividends is one which has been confined in its application generally to closely held corporations. This is clear upon examination of all the decided cases. A certain amount of unpublicized planning is virtually indispensible to dress up a dividend distribution as a distribution in partial liquidaton. Therefore, this procedure, by reason of its very nature, is not available to publicly held corporations and it has not been used by them.

Under sections 302 and 309 distributions by publicly held corporations which are essentially distributions in liquidation will be taxed at the higher rates applicable to ordinary dividends. In addition, in those cases to which section 309 is applicable, a tax equal to 85 percent of the amount distributed is imposed upon the distributing corporation.

Adding to the harshness of this result is the provision which in effect gives retroactive application to bases in which nonparticipating stock was issued prior to January 1, 1954, even though there was no design to siphon off corporate earnings through the subsequent redemption of such stock.

The now famous decision in *Chamberlin* v. *Commissioner* (207 F. 2d 462 (C. C. A. 6, 1953)) has been cited in the report of the Ways and Means Committee (p. 36) as the reason why it was necessary to enact section 309. But that was a case involving a very small corporation, the stock of which was very closely held. Chamberlin and his wife together held 83 percent of the stock. In addition to them there were five other shareholders. The sale of the stock to an insurance company was contemplated at the time of the preferred stock issuance.

It is manifestly unfair and clearly unreasonable and unrealistic to attempt to correct the abuse of the bailout procedure adopted in the Chamberlin case by providing that it shall be applicable to stock issued by a public corporation with no intention or thought of using that procedure. Section 309 lumps the innocent with the guilty. Less destructive and less drastic means are available to prevent future Chamberlin cases.

In order to give your committee some idea of the extent to which section 309 would impose the 85-percent tax we refer briefly to one or two typical situations:

(1) In 1932 corporation A, the stock of which was very widely held, needed $20 million additional capital. It decided to raise this by means of an issue of preferred stock with a par value of $100 per share. It was difficult to obtain additional capital at that time and hence, in order to sell the stock, it had to provide for a high dividend return. The issuing company believed, however, that in due course of time it might be able to obtain the additional capital which it needed at a lower dividend rate or, if bonds were subsequently used, at a lower interest rate. Consequently, the company reserved the right under the preferred stock issue to call it at premiums ranging from 25 percent down to 6 percent.

At the present time the corporation would like to call part of the stock and take advantage of the lower dividend and interest rates now prevailing. It should be mentioned that the stock, in accordance with the charter requirements, was first offered in 1932 to existing stockholders. In other words, their preemptive rights were recognized. If the company redeems the stock now, it will have to pay a premium of $25 per share.

Under section 309 there will be a transfer tax imposed upon the corporation of 85 percent of $20 or $17 on each share of stock redeemed from those shareholders who hold less than 1 percent of the common stock of the company. In addition, this class of shareholder may have a capital gain tax of $6.25 per share to pay on a capital gain of $25 at the time the stock is redeemed. The last conclusion is based on the view that under the proposed provision as now written, two taxes will be imposed on the distribution in redemption and that no offset will be allowed the shareholder for $20 of the distribution which is taxed to the company. The committee report speaks of 85 percent tax as being imposed at the corporate rather than at the shareholder level since it is less complex to administer such a tax by a check on the corporate books than to attempt to trace sales of stock (p. 36). It may therefore have been the intention of the committee not to impose a capital gain tax upon the individual on the $20 gain that has been taxed to the corporation. The proposed code itself, however, does not appear to carry out this scheme if such was the intention. Whichever view be taken, it would seem that there would be a capital gain tax imposed upon the shareholder in the supposed case based upon at least a $5 gain.

In the case of shareholders owning 1 percent or more of the common stock the entire redemption price of $125 per share will be taxed as an ordinary dividend under section 302.

It is unfair in a case such as has just been described to treat the distribution in redemption of the preferred stock as a dividend upon the common stock. There is no disguised dividend in such a case and the transaction is entitled to treatment as a liquidating distribution resulting in capital gain.

Consider, however, the effect of section 309 upon this situation. Under that section the preferred or nonparticipating stock which was actually issued in 1932 is deemed to have been issued on January 1, 1954. Consequently, the 10-year period during which section 309 will be applicable will run until December 31, 1963. Section 309 provides that this is a bailout transaction similar to the situation in the Chamberlin case. This is not correct.

Reference has previously been made to the different rules which are applicable, depending upon whether the shareholder owns, on the one hand, less than 1 percent of the participating stock or, on the other hand, 1 percent or more of that stock. How is the corporation which redeems preferred stock in the proscribed manner to determine whether or not the shareholder holds less than 1 percent of the participating stock, after full effect has been given to the rules of attribution of ownership prescribed by section 311? Yet it is compelled somehow to make such a determination to determine its own liability under section 309.

In addition, assuming the shareholder holds 1 percent or more of the common stock, he would be taxable upon the full amount of the distribution in redemption of his stock as an ordinary dividend even though that stock might not be redeemed until 1980. Clearly, such cases are far removed from the class of redemptions which are essentially equivalent to ordinary dividends.

(2) The second typical situation results from the application of section 309 to cases involving sections 352 or 353 (a). The effect is to make section 309 applicable to redemption of stock which was received in connection with statutory mergers or consolidations, corporate acquisitions of stock, corporate acquisitions of property and corporate distributions of stock of controlled corporations. By this means the 85 percent tax under section 309 is made applicable to cases where, perhaps many years ago, stock was received in connection with a statutory merger.

Thus in 1948 corporation A might have absorbed corporation B through a statutory merger and pursuant to that merger the former stockholders of B might have received the equivalent of $60 per share payable one-half in common stock and the other half in preferred stock of corporation A. It is provided that corporation A can call the preferred stock from time to time by payment of a premium. It has not done so yet, however, since the stock has been selling substantially below par, and the company has bought the stock on the open market.

In this case, as in the former one, there is nothing suggesting a bailout. The terms of the merger were made without intention to pay dividends to the old B shareholders by redemption of the new preferred stock of A. Sections 302 and 309 operate to prevent corporation A from acquiring its preferred stock for a period of 10 years. Furthermore, stockholders who hold 1 percent or more of the common stock will be taxed upon the full amount paid on redemption of the preferred stock as if they had received a dividend.

It is not at all certain what portion, if any, of the assets of corporation B which was absorbed in the merger can be recognized as having been paid in for corporation A's preferred stock. That being the case, the 105 percent rule contained in section 309 (a) (3) fails to give adequate protection to the corporation. A further difficulty arises in this type of case because the preferred stock of corporation A may be deemed to be the preferred stock of corporation B. It may, therefore, be held to have been acquired for that preferred stock. Consequently, there would be no basis to which the 105 percent rule of section 309 (a) (3) could apply.

These cases illustrate just a small portion of the difficulties and objections that might arise in connection with sections 302 and 309 as presently written. We therefore respectfully urge the following suggestions for modification or changes in sections 302 and 309:

1. Existing law should continue to control at least with respect to redemptions of nonparticipating stock issued by publicly held corporations in connection with transactions consummated prior to the enactment of the 1954 code.

2. If sections 302 and 309 are to be applied at all to publicly held corporations, we suggest that the following modification of these sections should be made:

(*a*) The 1 percent test in section 302 (a) (5) should be stepped up to 5 percent and the 105 percent test in section 309 (a) (3) should be increased to 120 percent. These changes will still retain the necessary deterrent against tax avoidance and will permit redemptions consistent with redemption premiums that are typically offered by publicly held corporations.

(*b*) Where corporate mergers, consolidations or acquisitions under section 352 are involved or where a distribution of stock of a controlled corporation under section 353 (a) is involved, it should be made clear that in applying the 105 percent rule under section 309 (a) (3) property shall be deemed to have been paid for the preferred stock at least to the extent of the value of the preferred stock at the time of the transaction.

(*c*) It should be provided in section 302 that the amount to be taxed as a dividend in the case of a redemption of nonparticipating stock shall be not more than the excess of the redemption price over the amount paid for that stock by the shareholder. Consistently with this, the tax under section 309 should be limited to a tax on the portion of the transfer remaining after applying against the redemption price the cost of the nonparticipating stock.

(*d*) The 10-year rule in section 309 should only be applied to preferred stock actually issued on or after January 1, 1954.

SECTION 312 (C)—DEFINITION OF SECURITIES

The problem of determining whether an instrument issued by a corporation represents a stock, on the one hand, or indebtedness, on the other, is a difficult one and correction to prevent abuse is fully warranted.

Section 312 (c) of the bill attempts to remedy the situation by giving a very restricted definition to the term "securities" meaning an instrument which represents an indebtedness.

We believe, however, that the definition is much too restrictive in the case of publicly held corporations. The cases in which there has been abuse have been those involving some closely held corporations and perhaps particularly those instances in which there is a substantial correlation between holdings of participating stock and holdings of the alleged securities. A striking case of the abuse of the substitution of alleged securities for participating stock is *Bazley* v. *Commissioner* (331 U. S. 737 (1947)). In that case the shareholders of a small closely held corporation unsuccessfully contended they were entitled to the benefits of the provisions relating to reorganization exchanges where they exchanged part of their stock for debentures and thereby increased the liabilities of the corporation and saddled it with an annual interest payment. In the case of a publicly held corporation it is not feasible to load down the corporation with alleged liabilities and reduce its earnings available for dividends by imposing an annual interest charge running in favor of perhaps a very few of the shareholders. Neither is it possible in the case of publicly held corporation to capitalize with a "thin" capitalization.

We believe that section 312 (c) should be modified so that the definition of securities therein contained will not apply to publicly held corporations. We believe that it should be made clear that where a publicly held corporation owns 50 percent or more of the stock of a subsidiary, the latter should likewise be

treated as a publicly held corporation. In no event should the definition of a security contained in section 312 (c) apply to obligations which were issued prior to enactment of H. R. 8300. We believe that the courts may be expected to view strictly cases involving instruments previously issued under circumstances or on terms that indicate that essentially an equity position was created.

SECTION 336—PARTIAL LIQUIDATION

In the 1939 code, distributions in partial liquidation were treated as capital gains or losses, whereas those that were essentially equivalent to ordinary dividends were taxed as dividends. Under the bill, this same general scheme is followed. Section 336 attempts for the first time to give precise statutory definition to what constitutes a distribution in partial liquidation. The bill, however, goes too far in excluding from the concept of a distribution in partial liquidation distributions which are not essentially equivalent to ordinary dividends.

We have no objection to the desire to have greater precision and certainty in this area. The present state of the case law on the subject is, we think, in at least some confusion. Greater certainty is desirable. Certainty should not, however, be provided at the price of a strait-jacket definition of what constitutes partial liquidation. We believe that undue restriction and limitation mark the proposed bill on this point.

When a corporation actually curtails its operating business activities and the curtailment is more than a passing fancy, the occasion is a proper one, we submit, for a distribution in partial liquidation. So long as there is a bona fide present intention to curtail operating business activites and where such curtailment makes available for distribution assets that would not otherwise be distributed, in other words where distributions would not have been made of the assets as ordinary dividends, shareholders are entitled to treat the attending distributions, where in redemption of part of the stock, as capital transactions on which capital gain or loss will be realized. No one will contend that such a case as has just been described is not a distribution in partial liquidation from the standpoint of corporation law and conventional corporation procedure.

Section 336 as proposed, however, digresses from what has been accepted corporation law and procedure for many years, long prior to the advent of the 13th amendment. Section 336 provides that there must be a complete termination of one of at least two businesses conducted by the corporation. This eliminates at the outset the type of case described above. The corporation which conducts but one business can no longer, at least for tax purposes, make a distribution in partial liquidation. There is no justification and no basic need for any such sweeping restriction.

If a corporation conducts two businesses and one of them is completely terminated, that is not enough under section 336. The two businesses must have ben operated separately. This requirement would seem to be outside the basic concept of a partial liquidation.

Under section 336 the books and records for the two businesses must have been maintained separately by the corporation. If income, cost and expense records for both businesses are kept in the same book but show beyond question the expenses and income of each of the two businesses, will it be said that this statutory requirement is complied with? Must separate journals and separate ledgers be maintained for each of the two businesses? How are the items of overhead and other items which affect both businesses to be regarded and how shall the records on this phase be made?

A further requirement of the proposed definition is that 90 percent or more of the gross income for each year of a 5-year period immediately preceding the first distribution of at least two of the separate businesses must be other than personal holding company income, as defined in section 543. We recognize, of course, that the easiest and most obvious way to obtain the funds to make a distribution which is really intended as an ordinary dividend but which it is desired to attempt to pass off as a distribution in liquidation is to distribute and thus completely terminate that part of a corporation's business which consists of its investments. It seems to us, however, that there is no justification for requiring that 90 percent or more of the gross income for the preceding 5-year period for the entire corporation including the business terminated be other than personal holding company income as defined in section 543.

The proposed section is by no means clear whether the holdings and activities of the corporation with respect to its investment assets may constitute a separate business. It makes no attempt, assuming that such investments are not

a separate business, to apportion or allocate the income from them to the separate operating businesses of the company. If a corporation has two separate businesses, one of which is the manufacture of automobiles and the other of which is the manufacture of ships, and it completely terminates the ship-manufacturing business and then makes distributions in redemption of part of its stock pursuant to the plan, we fail to see why the distribution should not be treated as one in partial liquidation where all of the investment assets were retained for use in connection with the automobile business and none of them were liquidated and sold or distributed to shareholders. We are assuming in this illustration a case in which less than 90 percent of the gross income of the corporation was other than personal holding company income. If, on the other hand, the investments may be treated as a "separate" business, then any company with at least 2 separate operating businesses may terminate 1 and have a partial liquidation regardless of the size of the investments. This probably was not the intention.

The philosophy upon which this limitation is based would seem to be that a corporation cannot make a distribution in partial liquidation even if it completely terminates 1 of its 2 lines of business where its personal holding company income is more than 10 percent of the whole. The idea apparently was that in such cases the corporation must first liquidate its investment assets, rid itself of its personal holding company income, and pass out an ordinary dividend from the proceeds. The chamber strongly feels that no justification exists for this 90-percent rule just described.

Assuming, however, that some allowance should be made in recognition of the view that personal holding company type of assets should first be liquidated and the proceeds distributed as ordinary dividends, paragraph 2 of section 336 (a) might be changed to provide that the distribution must be attributable to the disposition of assets which, plus required working capital, would not yield the transferee of those assets gross income of which more than 10 percent would constitute personal holding company income. At least section 336 (a) should provide that if a taxpayer establishes to the satisfaction of the Secretary that a distribution is attributable to a bona fide reduction of the scope of any single business activity which does not produce more than a normal amount of personal holding company income, such distribution will qualify as one in partial liquidation despite the requirements of paragraph 2.

SECTION 359—ELIMINATION OF THE 25–400 PERCENT STOCK OWNERSHIP REQUIREMENT FOR CORPORATE ACQUISITION

Section 359 deals with various definitions relating to corporate organizations, acquisitions, and separations. As was the case under the old law, provision is made for cases involving the corporate acquisition of stock and the corporate acquisition of property. A new requirement has been inserted in the case of corporate acquisition of stock and corporate acquisition of property. One phase of the new requirement is that the shareholders of any company whose stock is acquired by another corporation or whose assets are required by another corporation, must own not less than 25 percent of the amount of the participating stock of each class of the acquiring corporation owned by the shareholders of any other corporation, the stock of which is acquired in the same transaction, or by the persons who just before the acquisition were shareholders of the acquiring corporation. Another aspect is that the shareholders of the company whose stock or assets are acquired must not own more than 400 percent of the amount of the participating stock of each class of the acquiring corporation owned by the groups just mentioned. These new requirements are, we submit, unnecessary and undesirable.

The justification for these requirements is not clear from the report of the Ways and Means Committee (pp. 39–40, A133). The only direct reference on this point in the committee report is to the claim that corporations may undertake corporate mergers or consolidations solely in the hope of distributing earnings to shareholders at capital-gain rates (p. 39).

What the proposed provisions (sec. 359 (b) (2) and (c) (1)) attempt to do is to overrule the decision of the Supreme Court in the case of *Helvering* v. *Minnesota Tea Co., et al.*, 302 U. S. 569 (1935). In that case, the Commissioner of Internal Revenue argued successfully in the Board of Tax Appeals (now the Tax Court), 28 B. T. A. 591, but unsuccessfully in both the Circuit Court of Appeals (76 F. 2d 797 and 76 F. 2d 806 (C. C. A. 8)) and the Supreme Court that where a small grocery store corporation was absorbed by the Grand Union Co.,

a large chain organization, there was no tax-free reorganization since the stockholders of the Minnesota Tea Co. were not in control of Grand Union Co. immediately after the transaction. They received 18,000 shares of Grand Union's stock, and the total number of shares of Grand Union outstanding at that time was some 239,000. The Commissioner contended in that case that there must be an 80-percent control in order for there to be a nontaxable reorganization. As just stated, both the higher courts rejected that contention.

The current proposal contained in section 359 (b) (2) and (c) (1) appears to be an attempt to revive, although in somewhat modified form, the view which was rejected in the Minnesota Tea Co. case. There is no reasonable justification for the imposition of the new stock ownership requirement.

We believe that it is correct to say that the economic development of this country has witnessed innumerable cases in which, as in the Minnesota Tea Co. case, there was an acquisition by a large corporation of either the assets or the stock of a relatively small business unit. In many of those cases the shareholders of the smaller unit have not been in any position to demand 25 percent or more of the stock of the acquiring corporation. In those cases as well as in other types of reorganization transactions covered by the old and new code there has not been any clear-cut disposition of all interest in the business. On the contrary, there has been in effect simply a combination of businesses in line with the normal economic pattern. We think that the taxing provisions should be kept in line with the normal consequences of our expanding economy. The 25–400 percent rule would be harmful to the economy and there appears to be no tax avoidance incidence that calls for it.

SECTION 391—EFFECTIVE DATE OF PROVISIONS RELATING TO CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Fair and reasonable provision must be made as to the effective date of sections 301 to 391. The chamber suggests the March 1, 1954, effective date be retained, so that taxpayers are not deprived of the immediate benefits of the new bill, but also that the provisions of the Internal Revenue Code of 1939 shall be applicable to distributions or transfers occurring after March 1, 1954, and before January 1, 1955, if no gain or loss would be recognized as to such distributions or transfers under the provisions of the Internal Revenue Code of 1939, but would be recognized under the provisions of the new bill.

Many taxpayers have tried to proceed with normal adjustments and readjustments of business enterprises during this transition period, relying on the bill and on the statements in the press releases of the House Ways and Means Committee and Chairman Reed. These businessmen should be protected by retention of the March 1, 1954, effective date. At the same time, other taxpayers should be protected against retroactive application of the corporate adjustment and distribution sections in situations where this would be detrimental.

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

Section 303 (b) (2) of the bill provides that the decedent's estate must own 75 percent of the outstanding stock of each of 2 or more corporations before they shall be treated as stock of a single corporation to be redeemed under the provisions of section 303 (a).

The chamber suggests this requirement is too high. The purpose of section 303 could be accomplished if the 75-percent limitation were reduced to 50 percent. This change will materially aid the policy of preventing forced sales of family-held businesses solely because of the impact of estate taxes.

SECTIONS 401–404, 501–505—PENSION AND PROFIT-SHARING PLANS

Although the provisions of the bill on pension and profit-sharing plans were intended to eliminate many of the needless technicalities of present law and Treasury regulations and to liberalize the rules for such plans, there are some instances in which the bill is actually more restrictive than present law. These provisions and some additional changes which should be made in the bill are discussed below:

Section 501 (e). Requirements for qualification and allocation of benefits

The proposed requirements for qualifying pension and profit-sharing plans would result in great hardship to many employers. Many plans which would qualify under present law could not meet the proposed tests.

For example, a typical small manufacturer with 500 regular hourly rated employees and 120 regular salaried employees could not obtain approval of a pension or profit-sharing plan covering only its salaried employees. The 120 salaried employees are less than 25 percent of all employees. Most of the key employees will be in the salaried group, so that the key employees test could not be met. Such a plan probably could qualify, however, under present law.

In order to overcome this difficulty, it is urged that the coverage classifications permitted by section 501 (e) (3) be of two broad general types—specific nondiscriminatory classifications and, where other classifications are used, a test based on the percentage of employees covered.

A plan that limits coverage to employees who meet any of the following classifications should be deemed nondiscriminatory regardless of whether any other conditions are met:

i. Who are compensated on an hourly basis;
ii. Who are compensated on a salary basis;
iii. Who have been employed for a minimum period not exceeding 5 years;
iv. Who are compensated at an annual rate in excess of a specified amount, which amount does not exceed $4,000;
v. Who have reached a specified age, which age is not more than 35 years;
vi. Who are employed in a designated plant, division, department, or other operating unit of the employer;
vii. Any combination of 2 or more of the above 6.

Similar classifications have been ruled to be nondiscriminatory under section 165 of the Internal Revenue Code of 1939. The provisions of the bill should be at least as liberal as those of present law.

Other classifications selected by the employer should be permitted if the percentage of employees covered meets the key employee and the 25 percent requirement now included in the bill.

The classification described above should be exclusive and not be further restricted by the proposed arbitrary rule that in some cases a plan cannot qualify if more than 30 percent of the benefits are for shareholders. Such a rule of thumb clearly has no place in determining whether a pension or profit-sharing plan should be exempt from tax. Many plans approved under present law provide that for a time at least more than 30 percent of the contributions are for stockholders. This is particularly true of pension plans if the stockholder-employees are older than the other employees. This inequitable limitation should be stricken from the bill.

A further difficulty is that a plan may disqualify at any time if the number of employees changes so that the percentage tests are not met. The Commissioner of Internal Revenue should be given authority to rule that plans continue to qualify notwithstanding the inability of the employer to meet the percentage requirements.

The proposed rules on allocations of benefits are in some cases more restrictive than the Commissioner's interpretation of present law. These should be outlined in broader terms.

Section 501 (e) (4) (A). Ratio of contributions and benefits in the case of pension plans

This section should make it clear that plans can provide:

1. Benefits which vary in accordance with length of service, age and country of employment.
2. Benefits for service prior to date of establishment at a lower rate than for service after date of establishment.
3. Benefits based on salary classes.
4. Benefits related to final pay.

Section 501 (e) (4) (B). Ratio of contributions and benefits in the case of profit-sharing or stock-bonus plans

This section should make it clear that it permits:

1. A plan, designed to provide retirement benefits, that excludes the first $4,000 of compensation from coverage, thus integrating with social security.
2. A plan that allocates employer contributions and forfeitures in direct proportion to compensation.
3. A plan that allocates employer contributions and forfeitures on the basis of reasonable employees' contributions, thus encouraging thrift.
4. A plan that allocates employer contributions and forfeitures partly on the basis of length of service, thus contributing to stable employment.

5. A plan, designed to provide retirement benefits, that allocates employer contributions and forfeitures in such a way as to buy units of annuity uniformly related to covered compensation, age, and sex.
6. A plan that varies allocations in accordance with country of employment.
7. A plan that uses a combination of the methods described above.
8. A plan that uses any method described above for 75 percent of the employer contribution and 75 percent of the amount arising from forfeiture on termination of service or for any other reason and allocates the balance in such a way that the total amount allocated to any employee in any year is not more than twice the amount allocated to him from the 75 percent portion.

Sections 503 and 505. Restrictions on investments and business transactions of pension and profit-sharing trusts

Sections 503 and 505 of the bill would impose on pension and profit-sharing trusts entirely new and unwarranted restrictions.

Section 503 (c) (1) provides that such a trust may lose its exemption if it "lends (to the employer) any part of its income or corpus without the receipts of adequate security and a reasonable rate of interest." However, section 505 (a) (4) encourages these trusts to invest in securities of the employer and permits such investments in an unlimited amount. Section 503 (c) (1) would be particularly restrictive in the case of partnerships. For many years the Commissioner has permitted partnerships to sell notes and debentures to their profit-sharing trusts in order to equate partnership employers with corporate employers. In order to eliminate this inequity and the difficulties which would arise in distinguishing between debt and equity securities, section 503 (c) (1) should be made inapplicable to qualified pension and profit-sharing trusts.

Section 505 would impose unnecessary restrictions on the investments of pension and profit-sharing trusts.

This section should be stricken altogether. The Internal Revenue Service now has wide control over the investments of pension and profit-sharing trusts under the statutory provision requiring such trusts to be for the exclusive benefit of the employees. This provision is continued unchanged in the bill. Furthermore, trustees are subject to many investment restrictions of local law as well as limitations in the specific trust instrument. The detailed and rigid provisions of section 505 are totally unnecessary and the imposition of such stringent investment rules will discourage the establishment of pension and profit-sharing trusts and place on the Internal Revenue Service a serious burden of policing trust investments.

If, despite the considerations noted above, Congress should consider it necessary to restrict the investments of pension and profit-sharing trusts, much of section 505 must be amended to provide more practical rules. Some of the problems inherent in section 505 are discussed below. Others doubtless would arise as any such section is administered. The list of deficiencies in the proposed bill again illustrates the advisability of removing this section altogether.

Section 505 (a). Definitions.

Many of the terms in this subsection need definition and clarification. This is true, in particular, of "receivables", "government securities", and "securities." These should be defined very broadly. For example, the term "securities" should include mortgages, notes, oil royalties, oil payments, etc., and should be broad enough to include any assets which may be received in the reorganization or liquidation of any investment. Also, it should be made clear that "securities" is used in the general sense and is not to be restricted by special definitions such as in section 312 (c). The term "government" should include State and other political subdivisions thereof. Moreover, many such trusts make loans to participating employees, often without security. The term "other securities" should be broad enough to include such loans. The term "real estate" should be broadened to include "real estate aand tangible personal property used in connection therewith" Frequently pension and profit-sharing trusts have an opportunity to acquire tangible personal property, such as machinery, in connection with the acquisition of real property. This is sound investment practice and should be permitted.

Section 505 (a). Valuation of assets

In determining whether the trust qualifies, the "value" of each asset must be ascertained on the last day of each quarter. The difficulties in valuing real estate and stock of closely held corporations are well known and such a pro-

vision clearly would lead to litigation. Furthermore, a trust would disqualify at any time if there is appreciation in the value of an investment subject to a percentage limitation or depreciation in the value of other assets. If such restrictions must be imposed on investments, the limitation should apply only when the investment is made and only on the basis of the cost or value of the investment to be made in relation to the cost or value of the investments already held.

Section 505 (a) (3). Investment in life-insurance contracts

This section should be broadened to permit investment in ordinary or whole life contracts. Such investments are permitted under present law and clearly are appropriate for pension and profit-sharing trusts.

Section 505 (a) (4) and (b) (1). Investment in securities of the employer

In determining investments allowed by section 505 (a) (4) in the securities of the employer, its subsidiary and parent, section 505 (b) (1) provides an unrealistic definition of parent and subsidiary corporations. In order to come within the definition stock ownership of 50 percent or more is required. It is recommended that this be liberalized to include 50 percent ownership or less than 50 percent ownership if in the aggregate a group of related companies are the primary stockholders.

Section 505 (a) (5). Investments in common trust funds

This section, which allows investments in regulated investment companies, should be broadened to permit investments in common trust funds as defined in section 584 of the bill.

Section 505 (a) (6) and (7). Percentage limitations on investments in real estate and securities

The 5-percent limitation on investments in securities of any single issue and on any one investment in real estate is too restrictive. Many pension and profit-sharing funds are small and are invested largely in bonds. As a practical matter, an investment of 10 percent in a single issue of high-grade bonds is sound. To diversify a $100,000 fund among 20 different bonds is an unnecessarily expensive procedure. Even in larger pension trusts, a 10 or 15 percent investment in the bonds of certain large utility systems is entirely sound. Many such trusts also invest heavily in short-term commercial paper which appears to be included in the definition of securities under section 505 (a) (7). Such investments provide an immediate yield on the employer's contributions while permitting the trustee to make permanent investments at various times during the year. Moreover, in any such trust a 5-percent limitation leaves practically no leeway to accommodate good-faith errors in valuation.

The 5-percent limitation on real-estate investments raises similar problems. Many pension and profit-sharing trusts have sound investments in real estate of more than 5 percent of the value of their assets. Such investments should be encouraged where beneficial to the employees.

These arbitrary percentage limitations should be removed altogether, made inapplicable to trusts where the total value of the assets is small, e. g., less than $500,000, or, at least, be amended to permit investments up to 10 percent of the value of the trust, or $25,000, whichever is greater. An acceptable alternative would be to permit trustees to invest in assets permitted under either the laws applicable to life-insurance companies or the laws applicable to fiduciaries in the State in which the trust is domiciled. Under such a rule, it would, of course, be necessary specifically to provide that the trustee could invest in the securities of the employer without regard to the local limitations.

An additional problem arises because of the limitation on the percentage of a corporation's voting stock which a trust may hold. Some trusts have considered the formation of real-estate companies under section 101 (14) of the Internal Revenue Code of 1939 and section 501 (c) (2) of the bill to own real estate which the trustee cannot hold directly. Investment in the stock of such companies should be permitted even though the trust owns all the voting stock.

Although we recognize the general desirability of prescribing rules to provide certainty and practicability, to some extent, the difficulties with both the percentage tests discussed above might be reduced by permitting the district director of internal revenue to approve exceptions to the percentage limitations where they do not run counter to the purpose of the trust.

Section 505. Penalties for violation of investment provisions

The proposed penalties for the violation of the investment provisions of section 505 are extremely harsh and completely out of proportion to the alleged harm

resulting from investments prohibited by the section. It is urged that trustees be given a reasonable period of time in which to cure any investment prohibited by the section.

Section 505 (b) (2). Effective date

The effective date of the investment provisions would be March 1, 1954, under the bill.

Trustees of employee's trusts have previously been free of such mechanical restrictions on trust investments. It seems unlikely that any real harm could result from the continuation of the rules of the Internal Revenue Code of 1939 until the enactment of H. R. 8300. On the other hand, it is probable that on March 1 many trustees had no actual notice of the proposals and many still may have no such notice. In view of the amendments which clearly are necessary in order to make section 505 practical, no one can know its precise requirements until a few days before it beomes law. It is obviously unfair retroactively to expose trusts to serious penalties during a period in which the exact investment requirements are uncertain. It is recommended, therefore, that the new provision should become applicable no sooner than 90 days after the date of enactment of this bill.

In view of the difficulties discussed above, it is again urged that the entire concept of section 505 be deleted from the bill. Such restrictive provisions as these will not protect employees' trusts but will, instead, harass trustees and increase the administrative burden of supervising these trusts.

OTHER PENSION AND PROFIT-SHARING PLAN PROBLEMS

In addition to the restrictions discussed above, there are certain technical aspects of the bill which should be clarified. These are outlined briefly below:

Gift and estate tax consequences

When an employee irrevocably designates a beneficiary of a death benefit or joint and survivor pension, it is probable that he makes a gift of a future interest. The $3,000 gift tax exclusion would not be allowable for such a gift and, under the usual plan, if the beneficiary of a survivor's annuity predeceases the employee after the employee's retirement, all rights to the survivor's annuity would be lost. Nothing would be paid to the beneficiary's estate and the employee would continue to receive the reduced pension. The gift tax would thus have been paid on nonexistent pension benefits.

It is urged that chapter 12 make clear that designating the beneficiary or survivor annuitant is not subject to the gift tax. This is consistent with section 2039 (c) which excludes from the estate tax interests in retirement plans.

It is evident from the context of subsection (c) of section 2039 and the committee report that the value of survivor annuities receivable under qualified retirement plans is to be excluded from a decedent's gross estate except that proportionate part attributable to the decedent's own contributions. However, the actual text of the sentence immediately following paragraph (2) of subsection (c) reads as follows:

"If such amounts payable after the death of the decedent under a plan described in paragraphs (1) or (2) are attributable to any extent to payments or contributions made by the decedent no exclusion shall be allowed for any part of the value of such amounts."

In the interest of clarity, it is suggested that this sentence be changed to read as follows:

"If such amounts payable after the death of the decedent under a plan described in paragraphs (1) or (2) are attributable to any extent to payments or contributions made by the decedent no exclusion shall be allowed for the part of the value of such amounts attributable to such payments or contributions."

It also should be noted that section 2039 contains a needlessly technical rule on the estate taxation of annuities received under qualified plans. Although the portion of the annuity attributable to the employer's contribution is intended to be excluded from the gross estate, the portion attributable to the employee's contribution is not. This could be simplified without material loss of revenue by applying the approach of section 72 (d) to such contributions. In lieu of taxing the value of the annuity purchased by employees' contributions, under such an approach any amount of annuity payment actually received would be excluded from the gross estate. For example, if an employee who has contributed $8,000 to the cost of a joint annuity dies after having received $2,500 from the

annuity, $5,500 would be includible in his estate, or if he had received nothing, $8,000 would be includible.

It also should be made clear that section 2039 applies to plans approved under the Internal Revenue Code of 1939.

Section 403 (c) (1). Plans qualifying under the Internal Revenue Code of 1939

This section should make it clear that an employer which established a plan before the enactment of the bill should have the option of having the plan continued to be tested for qualification under the Internal Revenue Code of 1939, rather than under section 501 (e) of the bill; that it should be permitted to amend the plan and retain the option; and that the same advantages and privileges of the bill pertain to these plans as to those under section 501 (e).

Section 501 (e). Multiple and joint plans

Some employers have two or more pension plans. It should be made clear that each plan may qualify either individually or when considered with the employer's other plans.

The bill should provide that groups of employers may create joint pension or profit-sharing plans in order to pool investments and mortality experience.

Section 501 (e) (3) (A) and (4). Requirements for qualification

It should be made clear here as well as in any other section involved that the 30-percent test and the ratio test apply to contributions for each year, not on the basis of the employee's entire term of participation under the plan.

Section 501 (e) (4) (A). Equity pension plans

The statute itself should permit so-called equity fund pension plans. This could be effected by amending this subsection to provide that benefits which may be valued actuarially in the year funded may be measured by such value even though the benefit payments may fluctuate with a cost of living index or with the value of the assets of the pension fund itself. This question is far too important to be left to administrative discretion.

It should be made clear that the last paragraph of section 501 (e) is not limited to trusts and that item 2 in that paragraph does not merely permit the use of a restricted group of beneficiaries but permits the establishment of widows' and orphans' benefit plans. Such plans should be encouraged.

Section 6033. Returns

Section 6033 would require pension and profit-sharing trusts to file annual information returns. Under present practice the trustee is relieved of this duty if the corporation files the requisite information. The Secretary should be given power to continue this practice.

SECTION 461 (C)—ACCRUAL OF REAL PROPERTY TAXES

The "general rule" under this section provides that if taxable income is computed under an accrual method of accounting, then any real-property tax which is related to a definite period of time shall be accrued ratably over that period.

The foregoing is restricted by the "special rules" limiting any real-property tax which would be allowable as a deduction for the first taxable year of the taxpayer beginning after December 31, 1953, to the extent that such tax is related to any period before the first day of such taxable year as the tax that shall be allowable as a deduction for such taxable year. This provision (sec. 461 (c) (2)) creates a hardship for taxpayers where either (1) the taxpayer or (2) the related tax period is on a fiscal-year basis.

An example of the hardships which will arise under section 461 (c) of the bill is set forth in the following illustration:

A taxpayer on a fiscal year ending January 31, 1954, has accrued a real property tax on January 1, 1954 (assessment date), for the fiscal period of the taxing jurisdiction from July 1, 1954, to June 30, 1955. Since this tax was deducted in the fiscal year ending January 31, 1954, this taxpayer would not be permitted to take any deduction for the next fiscal year ending January 31, 1955, and could only take a deduction for 7 months accrual for the following fiscal year ending January 31, 1956. The taxpayer in this situation would be required to defer a deduction for real property taxes for 15 months.

The tax deduction and the prepayment in the foregoing example will, of course, vary depending on the taxpayer's fiscal year. The inequities resulting from the application of this section are readily apparent.

Section 461 should be amplified by the addition of an optional provision to allow a taxpayer to continue taking deductions for real property taxes as he has in the past, or at least to alleviate the hardship to him during the transition period.

SECTIONS 531–536—ACCUMULATED EARNINGS TAX

The chamber of commerce commends the action taken by the House of Representatives on the accumulated earnings tax provisions to place some of the burden of proof in certain cases on the Commissioner and to provide for a dividends-paid deduction from accumulated taxable income where dividends are paid on or before the 15th day of the third month following the close of the taxable year. Unfortunately, the bill does not go far enough to remove all the inequities and discriminations in the present statute.

The chamber of commerce recommends two additional changes in H. R. 8300 as follows:

(1) Section 535 should be amended to permit a deduction in computing "accumulated taxable income" in an amount equal to the portion of the corporation's earnings which are retained for reasonable business needs;

(2) Sections 531 through 536 should be amended to make it clear that the tax on improperly accumulated surplus should not be imposed where a corporation has used capital to enter a new field of activity or has invested in assets of an operating company unrelated to its business.

Recommendation (1)

In measuring accumulated taxable income and in determining the accumulated earnings tax under sections 535 and 531 respectively, no adjustment has been provided for a corporation which has a proper need for a substantial part of its accumulated earnings but retains earnings in excess of those reasonably acquired. Thus a corporation requiring $100,000 in earnings but accumulating $110,000, pays the same penalty as a corporation requiring no accumulation in earnings and accumulating $110,000 in earnings. An adjustment under section 535 should be made in a case of this sort. The chamber recommends that section 535 be amended to permit a deduction in computing accumulated taxable income in an amount equal to the portion of a corporation's earnings which are retained for reasonable business needs.

In addition, the Commissioner should be required to prove the extent to which accumulations are unreasonable. If it is possible for the Internal Revenue Service and the courts to make a determination that earnings have been unreasonably accumulated, as they do not, it should also be possible for them to determine the extent of the unreasonable accumulations.

Recommendation (2)

Although current legislation is silent on the point, court decisions involving section 102 of the Internal Revenue Code of 1939 show careful attention has been paid to whether a corporation has used capital to enter a new field of business activity or has invested in assets unrelated to its business. Under the court decisions and the regulations a corporation undertaking any new activity may be faced with the threat of the accumulated earnings tax.

Sections 531 to 536 of H. R. 8300 do not specifically deal with unrelated investments or activities. However, section 533 (a) provides that if a corporation's earnings are permitted to accumulate beyond the reasonable needs of the business, this fact shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

These words are currently amplified in the present regulations under section 102, and they and the court decisions leave little dobut that a corporation deviating from an existing pattern does so at the risk of a penalty. For example, regulations 118, section 39.102–2, provides that in any determination of purpose to avoid surtax one matter to be considered is:

"(2) The investment by the corporation of undistributed earnings in assets having no reasonable connection with the business."

Section 39.102–3 provides that the nature of the investment of earnings is immaterial if, in fact, they are not needed in "the business."

This interpretation of the present section 102 and, no doubt, sections 531 to 536 of the new statute, has had a seriously deterring effect upon corporations where changes in the nature of their business are needed to lessen the impact of severe fluctuations in activity or because of changing consumer demands, in-

creased competition from foreign manufacturers or advances in industry. Corrective legislation is necessary to remove the unnecessary risk a corporation must take in entering a new field of activity.

Every day we see examples of changes in consumer demands, a shifting of activity from one part of the country to another, and the emergence of new products resulting from advances in industry. In addition, we see numerous cases where foreign factories compete successfully with domestic companies, compelling the domestic companies to find new products if they are to survive. In each of these cases the corporation losing business and finding itself in a situation where its profits are dropping sharply must take steps to diversify its activity, plan a gradual shift in product, or get out of business. However, too often the threat of a tax on accumulated earnings deters any change. A shift which would be advisable might also place the corporation in a business unrelated to that which it previously carried on and might for that reason give rise to the imposition of penalties under section 531.

In addition, where there is a serious decline in an industry, a management problem is presented when the corporation cannot expand into new activity. It becomes difficult to avoid losing key personnel. Where a management group has been built up and has operated well as an integrated unit, it should not be necessary to liquidate the company, lose the management group, and organize a new company with new equity capital because of the possible penalty under section 531.

It is difficult to believe the Internal Revenue Service would seriously attempt to impose a section 531 tax upon a corporation engaging in new activity in order to survive. Nevertheless the danger of imposition of such a tax exists.

The chamber recommends that sections 531 through 536 be amended to remove this danger and permit management to change operations or undertake new ventures with freedom from fear of penalty taxes.

The chamber believes the proper scope of the accumulated earnings tax is to provide a sensible and workable provision that will prevent tax avoidance without impinging improperly on good business practices. The revisions thus far passed by the House of Representatives will not doubt improve administration of the tax and make it more acceptable to all concerned. The additional changes hereby proposed would permit expansion of corporate activity where in the opinion of management such expansion is advisable, without restricting business operations because of the fear of management that the accumulated earnings tax may be applied.

SECTION 615—EXPLORATION EXPENDITURES

The deduction of mine exploration expenditures under section 615 of the bill, first provided by the Revenue Act of 1951, has proved to be entirely inadequate. If we are to have a strong mining industry with ample reserves for the future, either for war or peace, the $75,000 annual limitation on the deduction, and the 4-year restriction must be removed.

SECTION 736—PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST

The chamber appreciates the fine work the Ways and Means Committee has done in attempting to bring simplicity, flexibility, and clarity to the taxation of partnership provisions of the new bill. There are still several areas, however, in which the partnership problems are not completely solved.

For example, considerable objection has been raised to section 736 of the bill providing rules for the treatment of payments made to a retiring partner or his successor in interest. This section in part provides that amounts paid in excess of the deceased partner's capital interest shall, if the payments are determined as a percentage of partnership income, be treated as a distributive share of income or other items of the partnership allocable to the recipient as a member of the partnership. These amounts will not be included in the distributive shares of the remaining partners—at least not for the first 5 years.

The bill provides that where such payments are made more than 5 years after that date, and they are not amounts attributable to the recipient's capital interest, they shall not reduce the distributive shares of the remaining partners. Such payments shall be treated as distributions to the remaining partners and as gifts to the recipients.

Many large and small partnerships in the United States have long-standing agreements providing for the payment over a period of 10 years or more of a

specified percentage of earnings of the partnership to a retiring partner or a legal representative of a deceased partner. In these cases the new section 736 would shift the tax burden after the 5-year period to the remaining partners, even though the agreement had been made when no such limitation appeared in the Internal Revenue Code of 1939. An unjust and unexpected benefit would accrue to the retired partner or deceased partner's representative, with a concurrent obligation on the remaining partners to pay an unfair tax on this distribution.

To remove this inequity, at least in part, the 5-year limitation should be increased to 10 years. Secondly, all bona fide partnership agreements now in force should be exempt from the provisions of section 736, to relieve surviving partners who are now powerless to change or modify these agreements to compensate for the shift in tax burden.

SECTIONS 901 TO 958—INCOME FROM SOURCES WITHOUT THE UNITED STATES

The chamber has made extensive recommendations to the Congress stressing the need for liberalizing the tax treatment of income derived abroad. Many of these recommendations are in accord with President Eisenhower's proposals in his budget message and the statements of the Randall Commission, and they have been incorporated into the new bill.

SECTION 903—PRINCIPAL TAX

Some of the new provisions of H. R. 8300, however, do not meet the pressing requirements for constructive and helpful revision of the Internal Revenue Code. For example, the definition of "principal tax" in section 903 appears to restrict and narrow the foreign tax credit allowance rather than to liberalize it. It restricts the taxpayer to a choice of claiming the credit for foreign income taxes or "principal taxes," but not both as originally intended by Congress and recommended by the chamber.

The definition of a "principal tax" in section 903 specifically excludes most, if not all, foreign taxes as credits except those which are actually income taxes. If the intent of section 903 is to liberalize the foreign tax credit provisions, section 901 could be amended by allowing credits for both foreign income taxes and other principal taxes.

Taxpayers are also concerned that the definition of "principal tax," which appears for the first time in H. R. 8300, will add substantial confusion to the foreign tax credit problem. Over the years a number of foreign taxes have been determined to be "in lieu" taxes under section 131 (h) of the Internal Revenue Code of 1939, especially South American taxes, and they are so understood. Some taxpayers may suffer real detriment if "in lieu" taxes disappear and are succeeded by so-called principal taxes which are not clearly defined or understood. The chamber recommends the following amendments to correct the problems noted above:

(1) Income taxes, and taxes in lieu of income taxes, paid to foreign countries, should be continued to be taken as tax credits against United States taxes. Existing credit limitations as to "in lieu" taxes should be reviewed and interpreted in accordance with an expressed intent of Congress;

(2) In the alternative, if the committee does not adopt the first recommendation, it should amend section 901 to allow credits for both foreign income taxes and other principal taxes.

SECTION 923—BUSINESS INCOME FROM FOREIGN SOURCES

SECTION 951—INCOME WHICH MAY BE DEFERRED

Sections 923 and 951 of the bill will exclude the great bulk of American foreign source income from the preferential treatment urged by the President's budget message. The term "trade or business" in both sections has been defined narrowly to exclude the operation of wholesale establishments engaged principally in the purchase or sale of goods or merchandise. The term also excludes the maintenance of an office or employment of an agent, other than a retail establishment, to import or facilitate the importation of goods or merchandise.

Apparently the Ways and Means Committee was quite properly anxious to exclude from tax benefits those companies which risk no capital, have no office, and carry on no bona fide business activity abroad. The wish to exclude these marginal operators, however, may deprive many legitimate American businesses,

having permanent establishments abroad, from any tax credit or election to defer income from foreign sources.

No mention is made of important foreign investment and business activities such as agriculture, lumbering, marine and pipeline transportation and construction. House Report No. 1337 states at page A255:

"The recital in section 923 of 'factory, mine, oil or gas well, public-utility facility, or retail establishment' is not meant to be exhaustive. 'Other places of business' may include, for example, the operation of a bank or an air transporation business * * *."

This seeming clarification in the report is not sufficient to dispel the doubts and confusion among businessmen. A clear, general comprehensive definition of a "trade or business" could be achieved by providing that taxpayers must maintain bona fide "permanent establishments" [1] abroad from which business activities must emanate. Such establishments should properly hire full-time employees within the foreign country with general authority to negotiate contracts or otherwise carry on active business.

The exclusion from the term "trade or business" of offices or agents to import or facilitate the importation of goods abroad is, as now worded in sections 923 (b) (1) (B) and 951 (b) (1) (B) of the bill, entirely appropriate to make certain that fringe exporters do not participate in the tax incentives which should be extended only to those willing to take added risks of doing business abroad.

In addition to the difficulties of defining "trade or business" under sections 923 (b) and 951 (b), the percentage requirement tests in sections 923 (a) (3) and 951 (a) establish narrow and discriminatory limitations on the types of foreign income which may qualify for the lower tax rate.

Where subsidiaries are engaged within one foreign country in some of the covered activities as well as activities in a noncovered category which may well be an integrated part of the business, it might be difficult or impossible to meet the 90 percent gross income test of section 923 (a) (3) (A) (ii) and section 951 (a) (2). The carrying on of covered and noncovered activities by one foreign subsidiary in several foreign countries might require a separation of the business so as to qualify for foreign income credits and the election to defer branch income from foreign sources. Such a division would be wholly artificial and contrary to sound business policies.

The chamber has consistently recommended that necessarily special tax treatment of foreign business income should not be given to income only from particular business activities. It has advocated granting tax incentives for foreign investments so that all foreign business income is treated fairly and reasonably.

Section 923 (a) (3) (B) was apparently intended to prevent the benefit of the tax credit in section 37 from being applied to portfolio investment. It requires that a domestic corporation, either alone or in association with not more than three other domestic corporations, own more than 50 percent of the voting stock of the foreign corporation declaring the dividend before such dividend can be deemed to be business income from foreign sources. In many situations, local conditions govern the ownership of local corporations, and it may not be possible to acquire a majority ownership. The committee may wish to lower the 50 percent requirement to distinguish between portfolio and business investments perhaps by lowering the ownership requirements to 10 percent of voting stock, similar to the provisions of section 902.

SECTIONS 951–958—DEFERRED INCOME FROM SOURCES WITHIN FOREIGN COUNTRIES

Under section 923 (a) (1) of the bill, the 14-point credit provided in section 37 with respect to taxable income of a foreign branch seems not to apply unless the corporation elects to report the branch income on a deferred basis. No incentive, therefore, is given to corporations receiving foreign branch income unless the domestic corporation elects to have such branch treated as a separate entity for tax purposes.

The objective of the Ways and Means Committee in requiring the election under section 951 may have been uniform accounting treatment of income from sources within foreign countries so that a domestic corporation could either: (1) Elect to defer the tax on income from foreign branches, or (2) make the election but withdraw the income and pay taxes currently. The difficulties of treating all

[1] The term "permanent establishments" has already been defined and employed in more than a dozen tax treaties between the United States and other foreign countries.

foreign branches as separate and distinct entities apart from the corporation, however, include the adoption of new and uncertain accounting procedures, separate books and records, recognition of gain or loss between home offices and branch offices, and other unnecessary limitations. These will serve to discourage companies which, for sound accounting purposes, wish to continue paying United States taxes on foreign branch income as it is earned, rather than when it is withdrawn. Unless these accounting provisions are compiled with, companies cannot receive the 14-point credit under the bill.

The 14-point credit should be applicable to all foreign income and should be separated and distinguished from the matter of electing to defer income from sources within foreign countries. A domestic corporation with a foreign branch should not be denied the tax credit in section 37 simply because it does not report foreign income on a deferred basis, but discharges its United States income-tax obligation currently. This places an unfair burden on many taxpayers if future corporate tax rates are higher when the foreign income is received.

SECTION 1201–1241—CAPITAL GAINS AND LOSSES

The Ways and Means Committee report at page 82 notes that the treatment of capital gains and losses is not basically changed in the bill. The chamber fully realizes that budgetary problems and the need for continuing high revenue may have influenced the committee's decision not to change the tax rates on capital gains at this time, but we urge the problem be carefully reconsidered by this committee to encourage transactions and create new revenues and investments.

Eventual elimination of the tax upon capital gains has been a constant chamber recommendation. The rates applicable to capital gains should be reduced persistently. As long as a capital-gains tax exists, offset of losses and gains should be continued, but excess losses should be allowed against other income with the resulting tax reduction reasonably limited.

The capital-gains tax operates as a serious deterrent to the investment of capital in the equities of business enterprises. It also tends to reduce steadily the funds of risk capital available for new businesses, because the tax comes out of these funds. The tax lessens the stability and liquidity of markets, and seriously deters companies from undertaking new capital issues essential for the expansion of established businesses. The tax creates frozen positions in securities and real estate, thereby restricting business activity and the taxable income normally resulting from such activity.

SECTION 1223—HOLDING PERIOD OF PROPERTY

A technical correction should be made in the bill to insure uniformity of treatment for taxable events after the effective date of H. R. 8300 arising from disposition of stock received in a tax-free spin-off.

In 1951 Congress amended section 112 of the Internal Revenue Code so as to add subsection (b) (11) thereof, which permits the tax-free distribution of stock of a corporation a party to a reorganization even though no stock of the old corporation is surrendered in connection with the distribution. This is the so-called spin-off amendment. At the same time, Congress amended section 113 to add subsection (a) (23), relating to the basis for determining gain or loss upon a sale or exchange of stock received in a spin-off. This subsection provides that where stock is received on a tax-free spin-off, the basis of the old stock is to be divided between the old stock and the new stock received in proportion to their respective market values.

Under section 117 relating to capital gains and losses the general scheme of the statute is that property which is held for more than 6 months is entitled to treatment as a long-term capital gain when determining the tax effect of gains realized on sales. Furthermore, the general approach of section 117 (h) is that where property is received in connection with a tax-free transaction the holding period of the property received is determined by tacking the holding period of the old asset on to the holding period of the new asset. Despite this general approach, and apparently through an oversight, Congress did not amend section 117 in 1951 so as to provide specifically that stock received on a spin-off should take over the holding period of the original stock which formed the basis for the distribution.

In 1926, the Commissioner held in I. T. 2259, V-1 Cumulative Bulletin 18, that there should be "tacking" on holding periods for stock received in a tax-free spin-off under section 203 (c) of the 1924 act, although the language of article

1651 of regulations 65, in language similar to section 117 (h) (1) of the 1939 code, provided for tacking only in tax-free "exchanges." The Commissioner then felt that the "principle" of tacking was equally applicable even in the absence of a technical exchange. It is understood that the Commissioner has taken the position under the 1951 act that section 117 (h) (1) does not apply to stock received on a spin-off because the stock received on a spin-off was not technically "received on an exchange."

The general inequity of this result is recognized by section 1223 (5) of H. R. 8300 which provides that in determining the period for which the taxpayer has held stock received on a distribution, if the basis of such stock or rights is determined under the tax-free reorganization provisions of H. R. 8300, then the holding period of the stock in the distributing corporation is included in determining the holding period of the stock received on the distribution. This provision will correct the oversight in 1951 as to future spin-offs. However, it is believed that this provision should apply to all taxable events occurring after the effective date of the 1954 code, and it is not clear that this would be the case. Possibly it is intended that, under section 1223 (9) of the 1954 code, section 1223 (5) should be read as referring to basis under section 113 (a) (23) of the 1939 code. If so, this should be made clear that the provision is "applicable"; otherwise, section 1223 (5), by referring to section 307 (a) and (b), may be applied only to stock acquired after December 31, 1953.

This limitation is proper under section 307 which is a basis provision and should be applicable only to property acquired under the 1954 Act. However, section 1223 characterizes assets for purpose of determining gain or loss and should also be applicable to all taxable events taking place under the 1954 act.

In this connection, it should be noted that in general H. R. 8300 is applicable to taxable years beginning after December 31, 1953. (See section 7851, H. R. 8300.) It is not proposed to change this effective date in any way.

An illustration of this problem would be a situation in which the X company distributed stock to the Y company in a tax-free spin-off in December 1953. In January 1954 a stockholder of the X company (probably through an oversight) sold the stock of the Y company received on the spin-off. The tax liability of this stockholder for the calendar year 1954 will be determined under the new Internal Revenue Code but some question may arise as to whether the holding period of the stock of the Y company is computed merely by the lapse of time from December 1953 to January 1954, or whether the stockholder should add to this period of time the period of time for which he held the stock of the X company. Section 1223 (5) of H. R. 8300 indicates a broad intention to permit him to add the period during which he held the stock of the X company in determining the holding period of the stock of the Y company. However, unless there is clarification, this intent may be ineffective.

The following specific amendment would clarify the applicability of these provisions and make clear that the 1954 code is applicable to all taxable events after the effective date:

Section 1223 (5):

"(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution if the basis of such stock or rights is determined under section 307 (a) or (b), or so much of subsection (d) as does not relate to stock received in lieu of interest or money, or under section 113 (a) (23) of the Internal Revenue Code of 1939, there shall (under regulations prescribed by the Secretary or his delegate) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution."

To make the 1954 code properly applicable to all taxable events occurring after its effective date either

(1) Section 1223 (9) should clearly provide that section 1223 (5) relates to basis established under section 113 (a) (23) of the 1939 code as well as to basis established under section 307 of the 1954 code. This can be done by amendment to section 1223 (9) or by example in the legislative history showing the intent of section 1223 (9); or,

(2) Section 1223 (5) should be amended as set forth above.

SECTION 1514—CONSOLIDATED RETURNS

Section 1514 of the bill retains the rule of section 141 (c), Internal Revenue Code 1939, and imposes a 2-percent penalty on corporations filing consolidated returns.

Economic and legal considerations require that many businesses be operated through affiliated groups of corporations. There is no logical reason for taxing these businesses at a higher rate than those which are conducted by a single corporation. Closely affiliated companies clearly should be allowed the privilege of filing consolidated returns without the payment of this inequitable penalty.

SECTIONS 2001–2504—ESTATE AND GIFT TAXES

The new bill incorporates several of the chamber's recommendations to the House Ways and Means Committee, including the abandonment of the "payment-of-premiums" test on proceeds of life insurance on a decedent.

A new limitation was added to the estate tax provisions at section 2032 which should be substantially amended or abandoned. It revised section 811 (j) of the Internal Revenue Code of 1939 to provide that the executor may elect to value the gross estate as of 1 year after the decedent's death only if the aggregate value of the gross estate had declined to 66⅔ percent, or less, of the value at the time of death.

House Report No. 1337, at page 90, justified the limitation on the grounds that:

(1) the optional valuation provision was enacted during the early 1930's because by the time estate taxes were paid, property values had dropped substantially and sometimes the proceeds of sale would not pay the estate tax due;

(2) the optional valuation date tends to retard the distribution of assets included in the gross estate; and

(3) the existing provision frequently requires the valuation of property as of two dates, whether or not an estate tax is paid.

These reasons do not justify the action taken in section 2032 of the bill to restrict the option taxpayers presently have under existing law. The proposed restrictions will make the optional valuation procedure unavailable to taxpayers suffering substantial declines in property values. A net estate may completely vanish without the optional valuation provision becoming available in the following example:

	Value at date of death	Value at 1 year after death
Gross estate	$1,000,000	$700,000
Deductions	700,000	700,000
Net estate	300,000	0

Despite the disappearance of the entire net estate by the optional valuation date, the estate would be liable under the bill to an estate tax of approximately $65,000.

Section 2032 also creates differences of estate tax on estates of substantially similar value. For example, if 2 gross estates are each valued at $1 million at the date of the decedents' deaths, and each had deductions of $200,000, the results may be as follows:

(*a*) The estate declining in value $350,000 (more than one-third) will reduce the estate tax thereon by approximately $125,000;

(*b*) The estate declining in value only $325,000 (less than one-third) will not reduce the amount of estate tax due on the net estate of $800,000.

The chamber recommends that the optional valuation procedure under section 811 (j) of the existing law be preserved.

SECTION 6016—DECLARATION OF ESTIMATED TAX AND TAX PAYMENT SCHEDULE FOR CORPORATIONS

The new proposed system for advance payments of corporate income tax should be rejected by the Senate Finance Committee as a discriminatory measure against 10 percent of the Nation's corporations. If enacted, it will impose new obligations on the corporations to estimate their full year's taxable income and obtain cash to pay the tax during the year. It will have an adverse effect on the economy which may outweigh many of the business incentive provisions of the bill.

Under the proposal, in several years corporations will be required to pay half the tax before the end of the year. Corporations have already been forced to raise additional capital to accelerate their tax payments under the Revenue Act of 1950. Payments once due in quarterly installments after the end of the taxable year have already been advanced under the so-called Mills plans so that they will become payable in 1955 in two installments within the first 6 months following the end of the taxable year The new bill will further accelerate these corporate tax payments on an arbitrary form of "pay-as-you-go basis," except that it contains no forgiveness feature similar to the provisions of the Current Tax Payment Act of 1943.

The bill will require corporations to file declarations of estimated tax and make advance tax payments if the tax liability "can reasonably be expected to exceed $50,000." By 1959 a corporation on a calendar-year basis will be required to pay 50 percent of its estimated tax before the end of the year, and 50 percent in the following 6 months. This means additional working capital, equal to one-half the corporation's annual Federal income-tax liability, must be raised for tax payments. Such permanent capital requirements will have adverse effects on business expansion, capital expenditures, inventory planning, and dividend declarations.

Many of the beneficial business provisions of the bill may be compromised if the advance payment plan is enacted. The new provisions to liberalize depreciation allowances and grant optional treatment of research and development expenditures, for example, may be of limited use if corporations must use working capital to meet estimated advance tax payments instead of investing the funds in expansion, research, and development.

If one of the principal purposes of section 6016 is to even the flow of tax receipts into the Treasury, it might be advisable to decelerate the payments under the Revenue Act of 1950, thereby eliminating the uneven flow of corporate tax receipts.

SECTION 6416—CREDITS OR REFUNDS ON CERTAIN TAXES ON SALES AND SERVICES

Under section 6416 of the bill it appears that credits or refunds in the case of price readjustments and certain other cases covered by subsection (b) may not be made unless the person who paid the tax complies with subsection (a). This requires that he establish:

"(1) That he has not included the tax in the price of the article or service with respect to which it was imposed or has not collected the amount of the tax from the vendee; or

"(2) Has repaid the amount of the tax to the purchaser (in case of retailers' taxes) or to the ultimate purchaser (in the case of manufacturers' taxes and the tax on diesel fuel) of the article or service or, in any case within subsection (b) (2), has repaid or has agreed to repay the amount of the tax to the ultimate vendor of the article; or

"(3) Has filed with the Secretary or his delegate the written consent of such purchaser, ultimate purchaser, or ultimate vendor, as the case may be, to the allowance of the credit or refund or has obtained the written consent of such ultimate vendor thereto."

Under section 3443 (d) of the present Internal Revenue Code it is specifically provided that the three requirements described in the language quoted above do not apply in the case of a credit or refund arising as to price readjustments and other cases now generally covered under section 6416 (b) of H. R. 8300.

This change in substance is not mentioned in the report of the Committee on Ways and Means of the House of Representatives and it is believed that the omission of a cross-reference exempting section 6416 (b) from the conditions imposed by section 6416 (a) was omitted through inadvertence.

The change in the law which is apparently made by section 6416 of H R. 8300 would impose an impossible burden upon persons paying the manufacturers' excise tax. Section 6416 should be amended by inserting the following language immediately after the word "shall be allowed" in the third line of subsection (a): "(otherwise than under subsection (b))."

The CHAIRMAN. Mr. Stott. Make yourself comfortable, Mr. Stott and identify yourself to the reporter.

STATEMENT OF ALEXANDER L. STOTT, COMPTROLLER, AMERICAN TELEPHONE & TELEGRAPH CO.

Mr. STOTT. Mr. Chairman and gentlemen of the committee, my name is Alexander Stott and I am the comptroller of the American Telephone & Telegraph Co. The American company is the parent Co. of the Bell System, a group of companies engaged in providing telephone service throughout the United States.

We in the Bell System recognize that the revision of tax law is a most difficult problem, and we are greatly impressed by the tremendous accomplishment of the committee, its staff, and the Treasury Department in preparing H. R. 8300.

We would like to add our word of congratulations for their tireless work in this important task.

In its report on H. R. 8300, the House Ways and Means Committee stated that this bill was intended—

to remove inequities * * * and to reduce tax barriers to future expansion of production and employment.

We would like to call your attention to a few provisions of the bill which we feel are not wholly in accord with its stated purpose.

I shall try to make my discussion of these points as brief as I can. Therefore, I respectfully request the privilege of filing for the record a prepared statement, together with supporting memoranda covering these points in some detail.

The CHAIRMAN. Your statement and memoranda will be made a part of the record.

Mr. STOTT. Thank you, sir.

We feel strongly that a serious inequity is perpetuated in this bill by the continuation of the two-point penalty surtax on consolidated returns. This penalty surtax has been characterized as unjust from the time it was first proposed in 1932. The Senate Finance Committee made these comments about it at that time:

Your committee recommends that this additional tax be eliminated. It sees no justification for it. The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. No improper benefits are obtained from the privilege. It is difficult to justify the exaction of a price for the use of this form of return.

As recently as January of this year, President Eisenhower in his budget message to the Congress recommended that this penalty tax be discontinued.

The CHAIRMAN. Just a minute, please. How much revenue does that produce?

Mr. STAM. I think you have to consider that in connection with intercompany dividends because I think the two go together. It is about $270 million that is involved.

Mr. STOTT. The consolidated return merely recognizes that it is entirely proper for an enterprise conducted by a company and subsidiaries to be considered for tax purposes as a single group.

In the telephone business, a nationwide service is provided by the American company, 19 operating telephone subsidiaries, a manufacturing subsidiary—the Western Electric Co., and the Bell Telephone Laboratories. Our experience over many years clearly shows that

separate operating companies, each responsible for providing telephone service in a particular area, are necessary for the furnishing of the highest grade of telephone service and result in many benefits to the users of the service.

Moreover, because of legal, operational or other business needs, many other industries also have no choice but to operate through subsidiaries.

Under sound and commonly accepted accounting principles, the operations of such a group of companies are correctly reflected by consolidated balance sheets and income statements. The Congress, itself, in providing the option of determining taxable net income through consolidated returns, has recognized this fact. We feel there is no logical reason why consolidated returns should be burdened by a penalty tax for the exercise of this option.

So far as we know it is the only option that has a penalty attached to it.

We feel the penalty surtax is discriminatory. As I told you it applies only to corporations which must operate through subsidiaries. If such corporations file a separate return, the dividends paid by one corporation to another are subject to a burdensome tax on intercompany dividends. If they file a consolidated return, their income is subject to a discriminatory penalty surtax.

In either case, the income of this type of enterprise is subject to triple taxation; it gets taxed twice at the corporate level and a third time in the shareholders' hands.

Now, we feel this bill recognizes the unfairness of multiple taxation. We think it has taken a very constructive step in providing some relief to invidual shareholders from the double taxation of dividend income, but it provides no relief to corporations of our type, either from the tax on intercompany dividends or from the penalty surtax.

Our Bell System I think provides a very good example of the adverse effect of this tax. For several years we filed a consolidated return, primarily to reduce the impact of this costly tax on dividends. But, as the price of what we think is the legitimate elimination of these taxes on dividends, we have had to pay this costly 2-point penalty surtax. Now, these taxes are added to the cost of telephone service. So, they affect more than 100 million users of our telephone service and they have an effect also on our 1,300,000 shareholders who have invested their money in our business.

There are other important reasons why we feel this penalty surtax should be discontinued at this time——

The CHAIRMAN. Is your company a utility, as such?

Mr. STOTT. Sir, all of our companies are subject to utility regulations.

The CHAIRMAN. Is the American Telephone & Telegraph Co. a utility, as such?

Mr. STOTT. Yes, sir; it is a utility. We operate the long lines which connect all of the subsidiary companies' properties, and we are subject to the regulation of the Federal Communications Commission.

The CHAIRMAN. Directly on your company?

Mr. STOTT. Directly on our company, sir; that is right.

As I said, we feel that there are other important reasons for eliminating the penalty surtax now. Under the proposed bill our taxload as we see it will be about the same as it is under existing law. The bill

continues the 52 percent normal and surtax rate for another year and, unless the penalty surtax is removed, the Bell System will continue to pay taxes at a 54-percent rate.

In addition, this bill provides, starting in 1955, and continuing for 5 years, for an accelerated tax payment program, the effect of which will be to collect from corporations an additional half-year's taxes over that 5-year period.

In other words, corporations generally will be subject to an annual increase of some 10 percent in tax payments during this period.

Now, for the reasons I have stated, we respectfully urge——

The CHAIRMAN. Let me ask: Is that a factor which the Commissions consider in line with your rates?

Mr. STOTT. It is, sir. They will take this into consideration without doubt.

The CHAIRMAN. It becomes a tax, then, on the consumer, in effect; is that right?

Mr. STOTT. To the extent that we are able to get rates that provide us a fair return, that is correct. In the postwar period we have suffered a lag in getting rates which we feel are adequate. It has been a long, hard struggle, and to the extent that we have been unable to get compensatory rates, then it falls upon the shareholder.

Senator WILLIAMS. Assuming that this accelerated rate of payment was put into effect, you are assuming that it would necessitate increased rates, and, by the same token, you would indicate that after this five-year period there would be a corresponding reduction in rates.

Mr. STOTT. I am sorry if I indicated it would be increased rates. It would mean additional financing. We would have to go out and do some financing in advance, to the tune, in our case, of perhaps $250 million over the 5-year period.

Senator WILLIAMS. I beg your pardon. I gathered you meant it would be an extra rate to the consumer.

Mr. STOTT. I am sorry. I didn't mean to give that impression. It would mean, however, that we would have to go out and finance in advance, and financing has been a very large problem, sir, to us in this postwar period.

The CHAIRMAN. You have done it through debt, haven't you?

Mr. STOTT. We have done it through debt, through convertible debentures and through employee stock plans, to the tune of about $6.3 billion systemwise, of new money, in the postwar period.

The CHAIRMAN. Have you put out any stock issues, plain equity issues?

Mr. STOTT. No; we have put out six convertible debenture issues in the postwar period. Except for the last one, which is about half converted, they have been very substantially converted into stock.

For the reasons I have stated, Mr. Chairman, we respectfully urge that the committee give serious consideration to the elimination of the two-point penalty surtax on consolidated returns so as to restore equality of tax treatment as between separate returns and consolidated returns.

I would like to mention briefly three other provisions of the proposed bill that could have serious effects in the Bell Telephone System, although I am sure these effects were not intended in the drafting of the bill. We have discussed these provisions with members of the

staff of the Joint Committee on Internal Revenue Taxation, and with representatives of the Treasury Department and I am sure they have a clear understanding of our problems.

Further, as I requested earlier, we are filing detailed memoranda on each of these points, so that I will try to be very brief.

The first point is subsection 505 (a) (7) which limits the allowable investments for employees' trusts, including pension trusts. We feel it would have a very serious effect upon the ability of the Bell System to raise new capital. This subsection denies tax exemption to a trust if more than 5 percent of its assets are invested in the securities of one issuer, other than the employer.

Now, unfortunately, it seems that the term "issuer" is defined in the bill to include all members of an affiliated group with the result that, so far as the Bell System is concerned, the American Co. and its subsidiaries, including such large companies as the New York Co., the Southern Bell Telephone & Telegraph Co., the Southwestern Bell Telephone & Telegraph Co., and the Pacific Telephone & Telegraph Co., each with assets of over a billion dollars, would not be considered as separate issuers. They would be considered as part of the whole Bell System, you see.

Now, our inquiries reveal that the majority of existing pension trusts already have more than 5 percent of their funds invested in the securities of the Bell System companies, taken as a group, and so they would be unable to participate in future security issues of any Bell System company. And we feel this would be a very serious situation to us.

Up to now, in the postwar period, the Bell System has raised well over $6 billion of new capital to meet the Nation's needs for telephone service, and it still requires substantial amounts of capital for its future program. By denying the Bell System a major source of investment funds, this restrictive provision would, in all likelihood, have a material effect on our construction program and on the continued employment of 700,000 employees presently on our payrolls.

We urge your committee that this subsection be modified to remove this restriction, if possible. But if your committee feels the restriction cannot be eliminated, we recommend that the limitation be increased from 5 percent to 15 percent, and that it apply only to the securities of a single corporation, instead of including all members of an affiliated group.

The second provision that gives us trouble, sir, is section 461 (c) which relates to the accrual of real property taxes. This section requires, in the case of accrual basis taxpayers, that real property taxes which are related to a definite period, shall be accrued ratably over that period. The proposal seeks to bring the tax laws in harmony with a recognized accounting principle, but there are other accepted bases of accruing taxes and our companies use them, sir.

Now, to compel us to shift from one basis to another would, in many cases result in a serious distortion of our taxable income, and in financial hardship to us in the year in which we are making the transition, because a portion of our real property taxes would not be an allowable deduction in that year.

Perhaps I can explain it this way: Many of our corporations accrue and take as a deduction real property taxes in the year in which the

tax assessment becomes final and the tax liability is fixed. Very often, however, these taxes relate to a period of the taxing authority which extends beyond the tax year for which the deduction has been taken under existing law. Thus, the effect of this section would be to push ahead in whole or in part to a succeeding year the deduction which the taxpayer would normally claim in 1954 for taxes on properties situated in certain taxing jurisdictions.

Under the circumstances, we request that the provisions of section 461 (c) be made elective rather than mandatory.

The last item that gives us trouble relates to section 1621 of the new code covering the computation of taxable income under a consolidated return. This is a rather technical provision, but I might say that the existing regulations covering consolidated returns have been made a part of the new code in this bill. They have just been picked up bodily and put into the code. Except, with this important omitted provision. Now, this omitted provision permits the taxpayer to compute taxable income, under certain circumstances, without eliminating certain types of intercompany gains and losses, where the Commissioner determines it is appropriate to do so.

In explaining this omission, the report of the Ways and Means Committee stated that it understood that the Commissioner, in the exercise of his administrative discretion, has for many years permitted the filing of consolidated returns, without eliminating intercompany profits and losses where, in his opinion, no distortion of income tax or tax avoidance occurred; and it assumed the Secretary or his delegate will continue this practice in proper cases.

However, we feel that unless the omitted provision is made a part of the new code there may be some doubt as to the authority of the Commissioner to use discretion in this matter. We suggest, therefore, that a specific provision covering this point be included in section 1621, so there would be no doubt as to the Commissioner's authority.

In closing, sir, we respectfully urge that you give favorable consideration to these matters that concern us, and we particularly request that this long standing and inequitable two-point penalty surtax receive your consideration.

The CHAIRMAN. Thank you very much. We are glad to have you.

Mr. STOTT. Thank you, sir.

(The prepared statement of Mr. Stott follows:)

STATEMENT OF ALEXANDER L. STOTT, COMPTROLLER OF AMERICAN TELEPHONE AND TELEGRAPH CO.

My name is Alexander L. Stott and I am comptroller of the American Telephone and Telegraph Co. The American Co. is the parent company of the Bell System, a group of companies engaged in providing telephone service throughout the United States.

In its report on H. R. 8300, the House Ways and Means Committee stated that this bill was intended "to remove inequities * * * and to reduce tax barriers to future expansion of production and employment." We would like to call your attention to a few provisions of the bill which we feel are not wholly in accord with its stated purpose.

TWO-POINT PENALTY SURTAX

We feel strongly that a serious inequity is perpetuated in this bill by the continuation of the two-point penalty surtax on consolidated returns. This penalty surtax has been characterized as unjust from the time it was first proposed in 1932. The Senate Finance Committee:

"Your committee recommends that this additional tax be eliminated. It sees no justification for it. The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. No improper benefits are obtained from the privilege. * * * It is difficult to justify the exaction of a price for the use of this form of return."

As recently as January of this year, President Eisenhower in his budget message to the Congress recommended that this penalty tax be discontinued.

The consolidated return merely recognizes that it is entirely proper for an enterprise conducted by a company and subsidiaries to be considered for tax purposes as a single group. In the telephone business, a nationwide service is provided by the American Co., 19 operating telephone subsidiaries, a manufacturing subsidiary—the Western Electric Co., and the Bell Telephone Laboratories. Our experience over many years clearly shows that separate operating companies, each responsible for providing telephone service in a particular area, are necessary for the furnishing of the highest grade of telephone service and result in many benefits to the users of the service. Moreover, because of legal, operational or other business needs, many other industries also have no choice but to operate through subsidiaries.

Under sound and commonly accepted accounting principles, the operations of such a group of companies are correctly reflected by consolidated balance sheets and income statements. The Congress, in providing the option of determining taxable net income through consolidated returns, has recognized this fact. There is no logical reason why consolidated returns should be burdened by a penalty tax for the exercise of this option.

The penalty surtax is both unfair and discriminatory. It applies only to corporations which must operate through subsidiaries. If these corporations file separate returns, the dividends paid by one corporation to another of the group are subject to the burdensome tax on intercompany dividends. If they file a consolidated return, their income is subject to the discriminatory penalty surtax. In either case the income of this type of enterprise is subject to triple taxation; it is taxed twice at the corporate level and a third time in the shareholder's hands.

This bill recognizes the unfairness of multiple taxation. It has taken a constructive step in providing some relief to individual shareholders from the double taxation of dividend income but it provides no relief to corporations either from the tax on intercompany dividends or from the penalty surtax.

The Bell System provides a good example of the adverse effect of these provisions. For several years it has filed a consolidated return primarily to reduce the impact of the costly tax on intercompany dividends. But as the price of the legitimate elimination of this tax on dividends, it has had to pay the two-point penalty surtax. Clearly these taxes which add to the cost of telephone service affect unfairly more than 100 million users of the telephone and the 1,300,000 shareholders who have invested their savings in our business.

There are other important reasons why the penalty surtax should be discontinued at this time. Under the proposed bill the Bell System's taxload will be about the same as it is under existing law. The bill continues the 52 percent normal and surtax rate for another year and, unless the penalty surtax is removed, the Bell System will continue to pay taxes at a 54 percent rate. In addition, the bill provides, starting in 1955 and continuing for 5 years, for an accelerated tax payment program which will result, in effect, in an extra half-year's taxes being paid by corporations over this 5-year period. This means that corporations generally must meet an annual increase of some 10 percent in tax payments during this period.

For the reasons I have stated, we respectfully urge that the committee give serious consideration to the elimination of the two-point penalty surtax on consolidated returns so as to restore equality of tax treatment as between separate and consolidated returns.

There are three other provisions of the proposed bill that could have serious effects on the Bell System, which I should like to mention briefly. I am sure these effects were not intended. We have discussed these provisions with members of the staff of the Joint Committee on Internal Revenue Taxation and with representatives of the Treasury Department. We respectfully request the privilege of filing detailed memoranda on these points as attachments to this statement.

LIMITATION ON INVESTMENTS FOR EMPLOYEES' TRUSTS

The first is subsection 505 (a) (7), which limits the allowable investments for empolyees' trusts and would have a serious effect on the ability of the Bell System to raise new capital. This subsection denies tax exemption to a trust if more than 5 percent of its assets are invested in the securities of one issuer, other than the employer. Unfortunately, it appears that the term "issuer" is defined to include all members of an affiliated group, with the result that, so far as the Bell System is concerned, the American Co. and its subsidiaries, including such large companies as the New York Telephone Co., the Southern Bell Telephone and Telegraph Co., the Southwestern Bell Telephone Co., and the Pacific Telephone and Telegraph Co., each with more than $1 billion of asssets, would not be considered as separate issuers. Our inquiries reveal that the majority of existing pension trusts already have more than 5 percent of their funds invested in the securities of Bell System companies taken as a group and so would be unable to participate in future issues of securities of any Bell System company.

Up to now in the postwar period the Bell System has raised well over $6 billion of new capital to meet the Nation's needs for telephone service, and it still requires substantial amounts of capital for its future program. By denying the Bell System a major source of investment funds, this restrictive provision would, in all likelihood, have a material effect on our construction program and on the continued employment of the 700,000 employees presently on our payrolls.

We urge that this subsection be modified to remove this restriction. If your committee feels that the restriction cannot be eliminated, we recommend that the limitation be increased from 5 percent to 15 percent and that it apply only to the securities of a single corporation instead of including all members of an affiliated group.

ACCRUAL OF REAL PROPERTY TAXES

The second provision is section 461 (c) which relates to the accrual of real property taxes. This section requires in the case of accrual basis taxpayers that real property taxes which are related to a definite period shall be accrued ratably over that period. While the proposal seeks to bring tax laws in accord with a recognized accounting principle, there are other accepted bases for accruing such taxes. To compel a shift from one basis to another would in many cases result in serious distortion of taxable income and in financial hardship in the year of transition because a portion of real property taxes would not be an allowable deduction in that year. In the circumstances, therefore, we request that the provisions of section 461 (c) be made elective rather than mandatory.

CONSOLIDATED TAXABLE INCOME

The last item relates to section 1621 covering the computation of taxable income under a consolidated return. The existing regulations governing consolidated returns have been made a part of the new code with one important exception. The omitted provision, now appearing as a part of section 24.31 (b) (1) of regulations 129, permits the taxpayer to compute taxable income without eliminating certain types of intercompany gains and losses, where the Commissioner determines that it is appropriate to do so. In explaining this omission, the report of the Ways and Means Committee stated that it understood that the Commissioner, in the exercise of his administrative discretion, has for many years permitted the filing of consolidated returns without eliminating intercompany profits and losses where, in his opinion, no distortion of income or tax avoidance occurred; and that it assumed the Secretary or his delegate will continue this practice in proper cases. However, unless the omitted provision is made a part of the new code there may be some doubt as to the authority of the Commissioner to use discretion in the treatment of such intercompany gains and losses. We suggest, therefore, that a specific provision covering this point be included in section 1621 of the bill so that there may be no question as to the Commissioner's authority.

CONCLUSION

In closing we respectfully urge that the committee give favorable consideration to all of the points which we have discussed and we particularly request that the long-standing inequity of the two-point penalty surtax be removed.

I wish to thank you, Mr. Chairman, and the members of your committee for this opportunity to present the views of the Bell System on these problems.

ATTACHMENT A

EXEMPT ORGANIZATIONS—ALLOWABLE INVESTMENTS FOR EMPLOYEES' TRUSTS

SUGGESTION FOR AMENDMENT OF SECTION 505 (A) (7)

Section 505 (a) specifies allowable investments for employees' trusts including pension funds. It provides that exemption under section 501 (a) shall be denied if more than 5 percent of the assets of a trust are invested in the securities of one issuer, other than the employer. For this purpose, the Bell System, including the parent American Telephone & Telegraph Co. and its 19 subsidiary operating telephone companies, would be considered as one issuer.

Under no circumstance could a trustholder run the risk of denial of exemption; therefore, this provision of section 505 (a) would effectively prevent him from making additional investment or reinvestment in the securities of an issuer where the assets of the trust already include more than 5 percent of its securities. It is believed that this provision would hamper seriously the ability of the Bell System to finance its present construction program. A review made for us by three of the larger trustholders shows that 221 or 78 percent of the 283 trust funds which they hold, excluding those of the Bell System as an employer, already have more than 5 percent of their assets invested in securities of the Bell System. Seventy-one or 25 percent of these trust funds already have more than 10 percent of their assets invested in securities of the Bell System and 14 or 5 percent have more than 15 percent. Thus, it is obvious that the great majority of existing trust funds could no longer acquire new Bell System securities or replace their present investment in Bell System securities with other Bell System securities. When it is realized that pension trust funds are currently absorbing approximately one-quarter of all net new corporate issues, and that they will represent an increasing proportion of the future supply of funds for investment in corporate securities, it is apparent that a substantial portion of the market for Bell System securities will disappear.

It is possible that this provision would have a serious impact only on the Bell System; even so, it is of extreme importance that it be modified. Because of its nature, a large part of the telephone industry has developed as a single business enterprise as contrasted with other industries in which there are many separate corporations. As a result, the Bell System bears a very large portion of the responsibility for meeting the Nation's needs for an adequate communications system. During the postwar period, the Bell System has been engaged in a tremendous construction program which has required the raising of more than $6 billion of new capital. During this same period, all other corporations in the United States have raised a total of about $41 billion of new capital. Certainly, it would be unfair to apply a 5 percent restriction to a segment of our economy which had represented more than 12 percent of the demand for investment funds in recent years. The Bell System has programmed construction work for 1954 involving expenditures of $1,300 million which will require the raising of substantial amounts of new capital. Since this restriction would make it difficult and more costly to secure new capital, it would have a material effect on our construction program and the continued employment of the 700,000 employees presently on our payrolls. It would make it more difficult to meet the Nation's needs for ever-improving telephone service.

The 5 percent limitation included in this section is a new one not previously included in the Internal Revenue Code. We do not believe that it would be appropriate to introduce such a limitation without detailed study of its effect; therefore, we recommend that the section be modified to remove this restriction. If this is not done, we recommend that the limitation be increased to 15 percent. Further, we recommend that the definition of an issuer be revised so that each individual corporation, without regard to its situation as parent or subsidiary, be considered as an issuer.

ATTACHMENT B

GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION ACCRUAL OF REAL PROPERTY TAXES

SUGGESTION FOR AMENDMENT OF SECTION 461 (C)

With reference to the taxable year for which deductions may be taken, H. R. 8300 contains a new provision, section 461 (c), which requires, in the case of accrual basis taxpayers, that a real property tax which is related to a definite period of time shall be accrued ratable over that period. Special rules are pro-

vided to cover the transition to this basis. The provision is explained at page A162 of the Report of the Ways and Means Committee.

This subsection is open to a number of objections: viz., (1) the questionable necessity for such a provision; (2) difficulties in many cases of determining with accuracy the definite period to which a tax relates; (3) difficulties of determining the real or personal character of property on which a tax is imposed and difficulties of determining what particular kind of property is subjected to tax; and (4) most importantly, the serious financial impact on many taxpayers of the transition procedures provided in paragraph (2) of the subsection.

Contrary to the assumption made in the report of the Ways and Means Committee that existing law requires accrual of real property taxes, as some definite moment determined by reference to a lien or assessment date, the courts have recognized that there can be other methods of determining deductible accruals for real property and other taxes. See, for example, *Commissioner* v. *Schock, Gusmer & Co.* (137 F. 2d 750) and *Atlantic Coast Line Railroad Co.* v. *Commissioner* (4 T. C. 140 (Acq.)). In such cases the ratable accrual of taxes has been recognized. The criterion used was that inherent in section 43 Internal Revenue Code and in section 461 (a) of H. R. 8300, namely, that the method used should clearly reflect net income. It appears, therefore, that there is considerable question as to the necessity for subsection (c) of section 461 to authorize the ratable accrual of taxes for deduction purposes.

By its terms paragraph (1) of subsection (c) requires accrual of a real property tax related to a definite period of time ratably over that specific period. Those taxpayers who have had widespread experience with local property taxes know that there are many jurisdictions in which it is well-nigh an impossibility to determine with accuracy the definite benefit period to which the taxes relate. Such problems are greatly multiplied for those taxpayers, as public utilities, whose properties lie in or traverse many taxing jurisdictions. For instance, in the State of New York there are over 7,000 taxing units, each with its own tax assessment and collection procedure.

In some jurisdictions the State and local laws, ordinances and practices are confusing or silent as to the tax benefit period. In others, taxes for all local jurisdictions within a State or county are collected in one sum by the State or county authorities, regardless of the fiscal years or benefit periods of the subordinate jurisdictions. Such situations will be a new area for controversy between the Commissioner and taxpayers, merely substituting questions pertaining to relevant benefit periods for those questions relating to lien and assessment dates which have existed in the past.

The limitation of section 461 (c) to real property taxes also will create difficult problems. In the first place, a question will arise whether decisions, such as the Atlantic Coast Line case, relating to other kinds of taxes are to be overruled by legislation. Furthermore, any distinction between taxes on real property and personal property will require a close scrutiny of each item of property to determine the facts supporting its classification as real or personal, even though the local tax made no such distinction or the assessment was made in a lump sum without specification. It is well known that there is much disparity in classification of similar assets located in different States and much disagreement as to such classification. The problem is further complicated by the use of so-called "in lieu" property taxes. Confusion resulting from this distinction may well lead to considerable unnecessary litigation.

The last point which it is desired to make is of great importance to a large number of taxpayers. In paragraph (2) of subsection (c), special rules are provided for the transition from real property tax reduction procedures under the 1939 code to those provided in the new subsection. Under those rules a real property tax which was allowable under the 1939 code as a deduction for a taxable year which began prior to January 1, 1954, would continue to be allowable for that year. A real-property tax which under the 1939 code would be allowable as a deduction for the first taxable year beginning after December 31, 1953, shall be allowable for such first taxable year to the extent that it relates to a prior taxable period and to the extent it relates to such first taxable year. Thus, in the case of a calendar year taxpayer, a tax relating to the period July 1, 1953, to June 30, 1954, which was accruable on its lien date of July 1, 1953, would be deductible in full for 1953. However, only one-half of the tax for the following benefit period July 1, 1954 to June 30, 1955, would be deductible for 1954, the remainder being deductible in 1955 along with one-half of the tax for the benefit period ending in 1956. Obviously, for the year 1954 the taxpayer's net income will reflect a deduction for only a half year's real-property tax. This distortion

is even greater in a State, such as Washington, where the effect of a lien date of January 1, 1954, pertaining to a tax for the calendar year 1955 will prevent deduction of any real-property tax for 1954.

The distortion of income resulting from the transition provision will not be limited to isolated cases. Generally, lien and assessment dates, which are usually considered determinative of accrual under existing law, occur prior to, or in the first half of, the benefit period. Consequently, in a large number of cases of those calendar-year taxpayers who deduct real-property taxes as accruing on the lien or assessment date, no real-property taxes, or only a portion of a full year's amount, will be deductible in 1954. The serious financial repercussions of this situation for those taxpayers who bear large real-property taxes cannot be overemphasized. Such an abnormal increase in Federal income tax liability may well eliminate net earnings after tax and will unduly reduce funds which should be available for working capital or investment in new plant. It will be small consolation that such deductions may be recouped at some far distant time when the taxpayer ceases business.

It is suggested, therefore, that paragraph (1), subsection (c) of section 461, be revised to place it on an elective basis. This may be accomplished by changing said paragraph to read as follows:

"(1) *In general.*—If the taxable income is computed under an accrual method of accounting, then any real property tax which is related to a definite period of time [shall] *may if the taxpayer so elects* be accrued ratably over that period." [New matter italics; matter eliminated shown in brackets.]

ATTACHMENT C

IN RE H. R. 8300, CHAPTER 6, SUBTITLE A—CONSOLIDATED RETURNS

SUGGESTION FOR AMENDMENT OF SECTION 1621

Section 1621 prescribing the computation of taxable income of each includible corporation is a counterpart of section 24.31 (b) (1) of regulations 129 and is substantially similar thereto except for one important omission. The omission is the provision for the computation of net income for consolidated return purposes without disregarding certain intercompany gains and losses if the affiliated group so desires and the Commissioner approves.

In explaining this omission the Ways and Means Committee report states at page A303 that it is assumed the Commissioner will not deny to those groups which used this basis of computing on consolidated returns the right to continue to do so; that the committee understands the Commissioner for many years, in the exercise of his administrative discretion, has permitted the filing of consolidated returns without disregarding profit or loss on intercompany transactions where, in his opinion, no distortion of income or tax avoidance occurred; and that it assumed the Secretary or his delegate will continue this practice in proper cases.

Since no change in the existing practice is intended, it seems highly desirable to include in the bill specific statutory authority for this procedure, otherwise denial of such authority might be implied by omission of this provision.

The purpose of the provision in the existing regulations is to simplify and expedite administration of the consolidated return procedures in those cases where the elimination of intercompany profits and losses is both exceedingly costly and impracticable and merely shifts the tax effect from one period to another. Specifically, it is intended to cover situations in which one member of an affiliated group produces or manufactures materials or goods which are sold to the other members of the group for use in the latter's trade or business and not for resale in the normal course of business to persons outside of the group. From a practical standpoint, it is much simpler in these cases to pay the tax on the intercompany profits at the outset and thus avoid the numerous difficulties and problems hereinafter described.

American Telephone & Telegraph Co. and the other companies of the Bell System fulfilling the proposed statutory 80 percent control requirement furnish an example of a group in which elimination of intercompany profits and losses would prove extremely difficult and costly. In the American group, Western Electric Co. manufactures, procures, and supplies to the affiliated companies in the group, as well as to other companies in the Bell System, nearly all of the tens of thousands of items used in construction of permanent plant. Such items are included by the operating affiliates in their plant investment accounts and depreciated over the life of the property.

In the event the American Co. and those of its subsidiaries, including Western Electric Co., which would qualify as includible corporations, should join in a consolidated return, the omission of this provision from the proposed section may well be interpreted to require (a) the initial elimination of a substantial proportion of Western's profits from taxable income as reported in the return, (b) adjustment for tax purposes of the cost basis of items going into the capital accounts of the affiliated operating companies and, thereafter, (c) annual adjustments to the book depreciation of the operating companies for so long as any part of such investment remained in the accounts.

The capital accounts of the Bell System include tens of thousands of different kinds of items of supplies, equipment, and apparatus, the greater part of which are purchased from a through Western. Under such interpretation it would be necessary to break down the charges and credits too, as well as the balances in, such accounts and subaccounts in such detail as to permit the accurate determination over the life of the plant of the depreciation applicable to initially untaxed intercompany profits. The difficulties and unnecessary burdens which would be imposed on both the taxpayer and the Government through technical compliance with that procedure are obvious.

The American Telephone & Telegraph Co. and its affiliated companies filed consolidated income-tax returns for each of the years 1918 to 1933, inclusive, and a consolidated excess-profits-tax return for the year 1940. The Western Electric Co. was included as an affiliated company and in each return the intercompany profits were not eliminated from the consolidated taxable net income. This procedure was reviewed and permitted by the Commissioner of Internal Revenue and the consolidated taxable income was determined on that basis.

Consolidated income and excess profits tax returns were filed under sections 141 (j) and 448, Internal Revenue Code, for the years 1950 to 1952, inclusive, by the American Co. and those of its affiliated companies which qualified as "regulated public utilities" and such a return will be filed for 1953. Western Electric Co., not being a "regulated public utility" within the purview of section 448, is not included in these consolidated returns. Consequently, the question of elimination of intercompany profits and losses does not arise.

During 1951, when a substantial revision of the consolidated return regulations was published in tentative form, the American Co. submitted to the Commissioner a suggestion that the revised regulations contain an express provision waiving the requirement for elimination of intercompany profits and losses in transactions of the type described above.

In a letter dated July 10, 1951, the Commissioner of Internal Revenue advised the American Co. that its suggestion had been accepted in part and invited attention to the penultimate sentence of secion 24.31 (b) (1) of the regulations as promulgated, which read as follows:

"For the purpose of these regulations, a transaction not involving a sale or exchange of a capital asset or of property subject to the provisions of section 117 (j) shall not be considered an intercompany transaction if such transaction occurs in the regular course of the trade or business of the members of the group and if such members adopt, with the consent of the Commissioner and subject to such conditions as he deems proper, a consistent accounting practice of taking into account in the computation of consolidated net income the gains and losses reflected in such transactions."

It is this sentence which has been omitted in the last paragraph of section 1621.

The American Co. and its affiliated companies intend to file a consolidated income-tax return for the year 1954. Section 448 no longer being in effect, such return must be made in accordance with the provisions of section 141 of the Internal Revenue Code or its counterpart in H. R. 8300, should that bill be enacted. Those provisions require the inclusion of Western Electric Co. and, consequently, an application will be made to the Commissioner for his consent to the inclusion in consolidated net income of the intercompany Western Electric profits. In order that there may be no question as to the authority of the Commissioner to grant such consent, it is respectfully requested that there be inserted in section 1621, immediately preceding the last sentence thereof, a provision embodying the existing language in section 24.31 (b) (1) of regulations 129 (with necessary changes in terminology) expressly permitting the Secretary or his delegate, in proper cases, to consent to the inclusion in consolidated taxable income of intercompany profits and losses.

The CHAIRMAN. Mr. Halvorson.

STATEMENT OF LLOYD C. HALVORSON, ECONOMIST, THE NATIONAL GRANGE

Mr. HALVORSON. I am Lloyd Halvorson, economist for the National Grange, with offices at 744 Jackson Place, NW., Washington 6, D. C.

The National Grange has a committee on taxation and fiscal policy. The recommendations of this committee come before the delegate body for action. Last fall the National Grange adopted the following principles of taxation:

(*a*) Taxes should be equitable.

(*b*) Ability to pay and benefits received should be dominating factors in the levying of taxes.

(*c*) Tax rates should be definite and should be known to the taxpayers. The levying of hidden taxes should be avoided.

(*d*) The tax base—including National, State, and local taxes—should be broad, so that the burden of taxes will be as widely distributed as possible, in conformity with these principles, in order that the public will have a direct interest in Government expenditures.

(*e*) Taxes should be levied for securing needed revenue, but should not be levied primarily as a means of social reform.

(*f*) Federal, State, and local governments should have different sources of revenue to as great an extent as possible in order to reduce multiple taxation.

The National Grange is deeply concerned with the high level of Federal expenditures that now exists. There is much desire for tax reduction among our members but not by deficit financing and increasing the Federal debt. The objective of our economic and tax policies is to maintain a sound and prosperous national economy with a gradual reduction of the public debt. Unless we are able to reduce Federal expenditures this objective will be difficult to attain.

Last January the executive committee of the National Grange took the following action:

> The executive committee noted that while the President's budget proposal calls for $6.5 million less expenditures in fiscal 1955 than in 1954, there is contemplated a budgetary deficit of $2.9 billion, largely because of tax reductions which recently went into effect and were voted by Congress last year. It was agreed that if budgetary expenditures cannot be further reduced, it would be sounder and more realistic to accept the deficit than to seek a return to the repressive tax rates in effect last year.
>
> In view of the cessation of inflationary pressures, it was felt that a budgetary deficit would not cause further depreciation of the dollar. Because of present unsettled economic conditions, it was decided the Grange would favor raising the debt ceiling to recognize the fact that if even a moderate recession should occur, tax receipts would fall off; and that to raise tax rates in such a period would serve to promote the recession.
>
> The committee decided to favor maintaining the present excise tax rates for another year because the emergency for which they were enacted is not yet over. They also decided to favor such tax revisions as clearly necessary to establish equity and feasible administration, but felt that the dividend credit should be postponed until budget expenditures could be further reduced.
>
> The committee reaffirmed the position of the Grange looking forward to a balanced budget and eventual beginning of public debt reduction. The Grange has historically opposed Federal automotive excise taxes and will seek their elimination first of all when the budget permits tax reduction.

It was a disappointment to the National Grange that the Congress did not give priority to automotive excise taxes when it reduced the excise taxes by about a billion dollars. We feel that before any general

reduction is made in income taxes that automotive excise taxes should be reduced and eventually abolished.

Senator LONG. Is there any particular reason why you should want to remove automotive excise taxes over removing taxes on household appliances and things of that sort?

Mr. HALVORSON. Yes; there are several reasons. Probably the main reason is that the Federal automotive excise taxes apply to gasoline, tires and tubes, and parts, used on tractors, and, theerfore, the farmers get taxed on that production expense, you see.

Secondly, we feel that these taxes should be reserved for the States because they need the money so badly for their own road expenditures.

We endorse the principle of continuing the regular corporation income tax rate at 52 percent. It is sound procedure to remove inequities and depressing tax provisions before reducing the tax rate.

We have not been able to evaluate all the tax revisions proposed in H. R. 8300, but we would like to express our support for certain provisions that we consider very desirable.

For a number of years farmers have been sorely vexed by bureaucratic decisions as to years of useful life of farm property and the method of allocating depreciation over the useful life. The length of life of farm equipment and machinery varies more than in any other segment of our economy because on a small farm a tractor will last longer than on a large farm where the tractor is used early and late most all the days. Also, the care of farm machinery and equipment varies greatly between farmers. Unrealistic depreciation policies can greatly interfere with farm investment policies, and therefore, efficiency.

Our executive committee on April 22, 1954, took the following action on depreciation:

> Voted to ask the National Grange office to seek by legislation and by consultation with the Internal Revenue Service, a more realistic depreciation policy on farm machinery and equipment in regard to both length of useful life and method of allocating cost over the period.

I note that the new section on depreciation applies only to new equipment. This is certainly a help, but I do not believe it will be very satisfactory as far as farmers are concerned. They are quite dissatisfied with the present depreciation policy on machinery they own, and it will be a long time before those who are now well stocked with machinery would get any benefit. It might artificially stimulate some new machinery purchase, but should depreciation policy be used for this purpose? A more realistic depreciation policy applied to existing farm machinery and equipment will enable farmers to recover the cost sooner, and this will enable them to buy the equipment they need. With farmers, the limiting factor in buying modern labor saving equipment is available money in most cases.

We hope the section on soil and water conservation expenditures will be enacted as found in H. R. 8300. For several years the National Grange has tried to get the tax collectors to see the equity of allowing farmers to expense soil and water conservation expenditures. Expenditures for conservation is just what it says. It is to keep the farm from washing or blowing away and to maintain its tilth and fertility. Also, while a number of extraction industries get depletion allowances, farmers do not. Land is not an inexhaustible resource as some seem to presume. Much of our land has lost more than half of its

nitrogen and humus content since it was opened. For this the farmers have been allowed no depletion allowance. It has also been a paradox that an earthen structure has not been depreciable, while structures of brick, made by hardening clay, is depreciable.

It is important to retain the provision limiting the right to expense soil and water conservation expenditures to land already in farming. It is also important to limit deductions to 25 percent of gross income derived from farming to prevent rebuilding of farms by nonfarmers from nonfarm income sources as a hobby or as a device or converting regular income into capital gains. We feel it is important to allow farmers to stretch the expensing over as many years as they choose. To require that all the soil and water conservation expenditures be deducted in the year of outlay or even over 4 years would deprive farmers in the middle and lower income tax brackets the full benefit of expensing.

We endorse the provision moving the tax filing dates to April 15 and extending the tax declaration date and the alternative final filing date for farmers by 15 days. In 1952 our delegate body adopted a resolution calling upon the Bureau of Internal Revenue to provide farmers with more instructions and aides for the filing of farmers income-tax returns. The Extension Service has put out annual bulletins to aid farmers in making out their tax returns, but with the present January 15, January 31, and March 15 compliance dates, not enough time for proper distribution of the tax help bulletins has been allowed.

The National Grange delegate body adopted a resolution favoring the proposal that fishermen be permitted to report and file their Federal income tax on the same basis and in the same manner as farmers, since they are unable to estimate in advance the income they will receive during the year. The bill before this committee has no such provision and we ask that it be included in the appropriate place.

We have some granges in California that have some fishermen members. I have also talked to Charles C. Jackson, the national manager of the Fisheries Institute, and he asked me to say that his organization is also in favor of including such a provision in this bill.

The National Grange reaffirmed its position in opposition to any change in the Federal tax laws that would place an unfair burden upon mutual insurance companies. The National Grange is opposed to the taxation of net patronage margins of cooperatives as corporate income.

We endorse the provisions in the bill which allows a parent the $600 exemption even if the child under 19, or a student, earns more than $600. The more liberal provision for deduction of medical expenses is the right way to help people pay their medical bills on their own. The increase in the charitable contribution limitation for individuals from 20 percent to 30 percent is in line with the Grange desire to promote charitable, educational, and religious organizations, and hospitals.

That concludes my testimony.

Senator LONG. May I ask some questions, Mr. Chairman?

The CHAIRMAN. Yes.

Senator LONG. Have you taken into consideration in your statement that it might be well to have certain tax reductions even if it does

result in an unbalanced budget, for the purpose of preventing a further recession or heading off a depression?

Mr. HALVORSON. The National Grange does not feel that the time has come that it is clear that we need such action; that if it does become clear, in other words, if in the next month or so there is a further increase in unemployment, I feel confident that the Grance would favor such a measure.

Senator LONG. Would it seem to you that it is easier to head of a depression in its incipiency, than to try to correct the ones you are in the midst of?

Mr. HALVORSON. As an economist I certainly agree with the implication of that question, and that is that it is much easier to stop it at the incipient stage than trying to get out of a depression.

Senaor LONG. In other words, it is like taking a medicine. A smaller dose in the first stage of the disease might cure the illness and if you wait until the patient is badly infected, it might take a great amount?

Mr. HALVORSON. That's right.

Senator LONG. I notice Professor Slichter recommended reduction of these taxes, which includes what you have in mind, in an article about a week ago in the New York Times magazine section.

Mr. HALVORSON. I would say probably the greatest disappointment of the Grange in excise reduction was that the Congress did not give priority to the Federal automotive excise taxes.

Senator LONG. Thank you.

The CHAIRMAN. Thank you very much.

Mr. Alvord.

STATEMENT OF ELLSWORTH C. ALVORD, WASHINGTON, D. C.

Mr. ALVORD. Mr. Chairman, gentlemen of the committee, if I may, I would like to file with the committee for its hearings a memorandum which we have prepared, directed toward those provisions of the bill now under consideration.

Now, I will proceed for just a few minutes to cover what I consider a few of the more important points.

The memorandum, I might add, has been prepared by four of the attorneys in my office, all of whom are very well known to this committee, Messrs. Karl Price, Lincoln Arnold, Fred Peel, and Charles Johnston, with such editing as I have been able to give it, and I hope that it will be of some help to the staff and some help to this committee.

I really wish personally to congratulate Mr. Stam's staff and the Treasury staff for the terrific job that they have accomplished in this new code. There are, as is to be expected, errors, technical errors, and errors of policy.

Mr. Chairman, we are in almost daily contact with Mr. Stam as to the technical errors, and the memorandum I am submitting does not cover them. There are, however, a few serious errors in the bill.

First, I would say there are serious errors with respect to omissions. For example, I heartily endorse the President's recommendations in his budget message with respect to the gradual elimination of the tax on consolidated returns and the tax on intercompany dividends, both of which have been omitted from the bill, I understand, primarily for revenue purposes. I think they should be restored.

There are other omissions, such as the one obvious means of increasing revenues. That is a substantial reduction in the tax on capital gains. A 10 percent tax on capital gains, Mr. Chairman and gentlemen of the committee, will produce much more revenue than your present tax. Your present tax retards and substantially interferes with daily transactions and definitely discourages new investment.

The 10 percent rate would produce much more revenue. Then, I also have other suggestions with respect to the imposition of the capital gains tax which I ask this committee to consider.

There are provisions in the bill which are exceedingly important if we are to maintain our place in world trade. The 14 point reduction provision, made in accordance with the Randall Committee's recommendations, will be very helpful. There are some deficiencies in it which I don't understand. I know no reason why the movie industry should be excluded from the provision, if it is. I am not sure it is, but it might be. Nor do I understand why certain wholesaling activities are excluded from the benefits of the 14 point reduction. I urge that both be covered, and then I suggest one further point.

I have made this suggestion to the subcommittee of the Committee on Foreign Relations of the Senate. I think it would be very much worthwhile for this bill to contain a provision approving the principle that the President negotiate treaties with underdeveloped countries designed to stimulate the flow of private funds from the United States into the underdeveloped countries. That is the only manner, in my opinion, in which underdeveloped countries can become developed.

The CHAIRMAN. I would like to suggest there are more ways of developing an underdeveloped country; for the underdeveloped country to develop rules of fairness, not by treaty but by trying to encourage investment in practice.

Mr. ALVORD. Mr. Chairman, I think it should be done by treaty because an underdeveloped country may not wish funds, for example, from Russia. It may not wish funds from other portions of the world. If the underdeveloped country really wishes our funds, funds from the United States, help from the United States, it should be perfectly willing to enter into a treaty with us.

The CHAIRMAN. Treaties don't make any difference. They don't pay any attention to treaties. It is actual practice in the country.

Mr. ALVORD. I quite appreciate that that is one of the elements, and actual practice in the country is one of those roadblocks which keeps America out.

The CHAIRMAN. It is a very poor roadblock. A treaty is a piece of paper. They say, "Well, after all, if we don't live up to the treaty, we make Uncle Sam mad in a gentle sort of a way, and he won't do anything about it."

Mr. ALVORD. Mr. Chairman, I know of no tax treaty that has not been lived up to by the countries which have agreed to it.

The CHAIRMAN. I know of no country in this world, with few exceptions, that is entirely fair to American capital.

Mr. ALVORD. That I quite agree with, but I think that fairness will be brought about in large part, however, through the negotiations of suitable treaties which will adequately protect American investment over there and adequately provide for the manner in which the income from that investment will be taxed.

The CHAIRMAN. I am suggesting they don't pay much attention to the treaty when it suits their purpose. The point is, a sustained course of practice in the country that makes the investor feel his investment is safe, not what it says in the treaty.

Mr. ALVORD. With that, I agree. But that must be accompanied by a treaty, if there is such a sustained course of practice, and I think both together would, perhaps, do the job. I am not sure of it, but it might well do the job.

Then, with respect to the change in the foreign tax credit that also has to do with our activities abroad. It is a sort of a tossup as to whether we should eliminate its "overall limitation" or the "per-country" limitation. The Committee on Ways and Means has chosen to eliminate the "overall limitation." To that, I have no objection. I have recommended the elimination of one or the other, with my preference for elimination of the "overall."

I think there should be at least one more provision: That is, that if an American taxpayer does business in a foreign country, apart from business done by a foreign subsidiary, then whatever losses he has from such business should not be taken into account in applying the per-country limitation to the foreign tax credit allowed with respect to dividends he gets from the subsidiary.

That one provision will help tremendously in carrying out the policy which led to elimination of the "overall" limitation.

There is also a provision in the bill which is a substitute for the present law provision that a foreign tax credit shall be allowed for a tax "in lieu of income tax." In place of that provision, the bill will give a credit for a thing they call a "principal" tax. I have no particular kick on that. It is a brand new concept. I don't know just how it is going to be applied, but if we want to experiment with it, I would leave both provisions in.

Then, I might also add that the administration could well be encouraged to include in the double tax treaties, or in other tax treaties, a specification of the types of taxes in the foreign country for which a credit will be given by the United States.

I realize that your time is limited, Mr. Chairman. I have attempted to summarize a few of my recommendations for you. There are others waiting to get on and the committee wants to get through.

If there are any questions, I will be very happy to attempt to answer them, and I am making every effort to get through in 10 minutes.

The CHAIRMAN. That makes you a first-rate hero around here. I commend the gentleman's example to all other witnesses.

Mr. ALVORD. Thank you, Mr. Chairman.

(The prepared material of Mr. Alvord follows:)

STATEMENT BY ELLSWORTH C. ALVORD ON H. R. 8300 (INTERNAL REVENUE CODE OF 1954)

Mr. Chairman and members of the committee, my name is Ellsworth C. Alvord. I am a lawyer engaged in active practice in Washington, D. C.

RECOMMENDATIONS

(1) H. R. 8300 should be enacted as promptly as appropriate amendments can be prepared and adopted.

(2) The basic policy recommendations in the budget message which have been omitted from the bill should be adopted.

(3) The proclaimed policies of the present administration should be substituted for all the New Deal philosophy now embodied in the bill—much of it more drastic than the New Deal dared advocate.

(4) There is no necessity to eliminate the proposed codification, or to postpone the effective date of the bill as a whole until next year. Corrections can be made.

TECHNICAL ERRORS AND OMISSIONS

From the day on which the bill became public, we have been, and will continue to be, in almost daily contact with your experts in pointing out matters which seem to us to be unintended errors or omissions. These are not included in the memorandum I am submitting herewith.

BASIC TAX POLICIES

(1) Present tax burdens are heavier than even war or international tension can justify, and much heavier than the American system of free enterprise can carry for an extended period of time. If hope for continuing and early relief is lost, economic progress will stop. We need not and should not risk the gruesome consequences.

(2) The gradual elimination of the tax on the intercompany dividends (carried over from the completely discredited undistributed profits tax) and of the penalty upon an affiliated group for filing an appropriate consolidated return should be adopted.

(3) It should be recognized that the earnings of individuals are subject to depreciation and obsolescence, just as earnings from machinery are. Individuals should be permitted to work at least half their time for themselves, their families, and their churches, schools and charities.

(4) To increase revenues, to lessen the existing levy upon capital, and to remove one of the roadblocks discouraging the investment of private funds in revenue-producing business enterprises, the rate of tax upon capital gains should not exceed 12½ percent (a 10 percent rate is preferable); the system should be stabilized; the sale or distribution of assets held for more than 20 years should be tax-free; and normal shifts in investments should be permitted without a tax upon the "paper" profits.

(5) The principles of the present Western Hemisphere provisions should be extended to all income from foreign sources; and in any event the apparent denial of the 14-point benefits to certain industries (such as the movie industry and industries necessarily engaged, at least in part, in wholesaling) should be corrected.

(6) The negotiation of treaties should be encouraged in order further to remove the roadblocks to the flow of private funds to so-called underdeveloped countries.

(7) A system should be adopted for averaging excess-profits tax liabilities over all the years the tax was in effect.

SUMMARY OF COMMENT ON TECHNICAL POLICIES

(1) *Corporate reorganizations*

(*a*) Gain or loss should not be recognized in cases involving the acquisition by one corporation of the stock or the property of another corporation merely because one of the two corporations is more than four times as large as the other corporation.

(*b*) The "inactive corporation" concept in connection with "spin-offs" and "split-ups" should be discarded, or at least the definition of an "inactive corporation" should be so amended that it will not apply to any corporation which is engaged in the direction of a business enterprise through subsidiaries.

(2) *Corporate liquidations*

(*a*) The provisions of section 112 (b) (6) of the present code should be retained so that subsidiary corporations may be liquidated without the necessity of appraisals of their properties.

(*b*) The definition of partial liquidations should be broadened so as to include any contraction in the scope of a corporate enterprise.

(3) *Redemptions of corporate stock*

(*a*) The provisions of section 115 (g) (1) of the present code, relating to the taxation of stock redemptions as dividends, should be retained in lieu of the mathematical tests of section 302 (a) of the bill.

(*b*) The 85 percent transfer tax on corporations which redeem preferred stock issued as a dividend or in a recapitalization should be abolished, and instead stockholders who cause such stock to be issued with the intent to sell it and have it redeemed should be taxed upon the receipt of such stock.

(*c*) Distributions of inventory in redemption of stock should not be taxed as a dividend where the redemption is bona fide, and not essentially equivalent to a dividend.

(4) *Pension and profit-sharing plans*

(*a*) Plans should be permitted to qualify either under the mathematical tests set out in section 501 (e) of the bill, or under the general test of nondiscrimination in section 165 (a) of the present code.

(*b*) In applying the mathematical tests as to discrimination and the limitations on the employer's deduction for contributions, it should be possible to consider all of the employees of several affiliated corporations as if they were the employees of a single employer.

(*c*) The restrictions on investments of pension and profit-sharing trusts set out in section 505 of the bill should be discarded.

(5) *Retroactive provisions*

Provisions in the bill which would impose a tax where none would be imposed under present law should not be made applicable to transactions which prior to the enactment of the bill have been carried out; or, in the case of corporate transactions, approved by stockholders; or, in the case of proposed reorganizations, if a closing agreement under present law has been entered into. Examples are corporate reorganizations, long term stock options, and long term leases by employee trusts.

(6) *Foreign income*

(*a*) The 14 point tax differential on foreign income should not be denied in the case of any bona fide foreign operations, such as farms and plantations, timber operations, the distribution of motion picture films, and wholesaling.

(*b*) The right to the 14 point tax differential on income from a foreign branch of a United States corporation should not be conditioned upon electing to defer the income from such branch.

(*c*) The provisions permitting a deferral of income from a foreign branch should not be conditioned upon a forfeiture of the taxpayer's right to percentage depletion, nor should they deny an eventual realization of loss on the foreign branch operations, nor should they prevent the return to the United States tax-free of the United States corporation's initial investment in the foreign branch.

(*d*) The "principal tax" concept under the foreign tax credit provisions is even less satisfactory in some respects than the "in lieu of income tax" concept as administered by the Government today. Both concepts should be employed, and in addition appropriate treaty provisions should be negotiated to supplement these provisions.

(*e*) Direct operations of a United States corporation in a foreign country should be considered separately from the operations in that country of such corporation's foreign subsidiary, both for purposes of applying the "per country" limitation on the foreign tax credit, and also for purposes of computing the limitation on the 14 point tax differential.

(7) *Consolidated Returns*

(*a*) A new election should be granted annually.

(*b*) If an annual election is not granted, a new election should be granted whenever there are disadvantageous changes either in the law or the Regulations, whether or not "substantially" disadvantageous, and such new election should be allowed for the first year for which any such change is effective.

(*c*) There should be no compulsory inclusion in the consolidated return of Western Hemisphere trade corporations or of other corporations deriving most of their income from abroad.

(*d*) The inventory provisions relating to consolidated returns should be amended in order to avoid a double tax on intercompany profits included in inventory.

(8) *Operating loss carry-overs*

(*a*) The operating loss carry-over provision should be amended in order to allow full benefit for percentage depletion and for the deduction for intercorporate dividends received.

(*b*) The 5-year carry-forward provision should be made effective for computing the operating loss deduction for 1954.

(9) *Accrual of real property taxes*

Accrual basis taxpayers should be permitted, at their election, to continue to accrue real property taxes on the lien date.

(10) *Transferee waivers*

The execution by a transferee of a waiver of the statute of limitations on the assessment of deficiencies should be made to effect an extension of time within which to file claims for refund.

EARNED INCOME CREDIT

One of the most significant social changes brought about by our present heavy income tax rates is the fact that it is virtually impossible for a person to accumulate out of earned income a substantial reserve for his old age or an estate of sufficient size to support his widow or other dependents. The marginal tax rates on individuals now range as high as 91 percent, and the overall limitation of the average tax rate for individuals is 87 percent. The tax law no longer contains any recognition of the need to provide special treatment for earned income other than income earned abroad.

The need for relief in this area is emphasized in the proposed bill by the special treatment accorded investment income through the 10 percent credit for dividends received. The Government should never take more than half of the taxpayer's earned income. Provision should be made for an overall income tax rate limitation of 50 percent on earned income and a reasonable earned income credit for taxpayers below the 50 percent average tax rate.

DEATH BENEFITS FROM PENSION TRUSTS

Section 101 of the new code, like section 22 (b) (1) of the present code, provides for the exclusion of employee death benefits (paid otherwise than under a life insurance contract) up to a maximum limit of $5,000.

Subparagraph (B) of section 101 (b) (2) proposes to resolve an ambiguity of present law as to this exclusion by providing that the exclusion shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living, but subparagraph (B) is stated not to apply in the case of distributions from a qualified profit-sharing or stock bonus trust.

Neither the bill nor the report of the Ways and Means Committee explains why there is no similar exception in subparagraph (B) for distributions by a qualified pension trust. There is obviously no difference between a qualified profit-sharing and a qualified pension trust which is material to the allowability of the exclusion. Section 101 (b) (2) (B) should be amended by enlarging the exception to apply to distributions from qualified pension trusts also.

ACCIDENT AND HEALTH PLANS FOR EMPLOYEES

Section 104 of the bill continues the present exclusion from gross income of amounts received through accident or health insurance for personal injuries or sickness, but that section and section 105 qualify this exclusion by providing that amounts received by an employee under an "employer's accident or health plan" shall be excluded only if the plan is a "qualified plan" under section 105 (c), and only up to a maximum limit of $100 per week.

One of the essential elements of a "qualified plan" is that it shall provide a "waiting period before the time when payments are to begin under the plan." Neither the bill nor the report of the Ways and Means Committee indicates that this waiting period need be of a prescribed minimum duration, and there is no suggestion of a policy which would require a minimum of any particular length.

Nevertheless, to avoid controversy in individual cases, the bill should specify that a waiting period of 1 day will be required.

Furthermore, such plans should be denominated "employer's plans." This terminology is unnecessary, and it might be deemed to exclude from section 105 any plans initiated and controlled by employees, although supported in whole or in part by employer contributions. It also might be deemed to imply that a plan which qualifies under section 105 is not entitled to an exemption as a

voluntary employee beneficiary association under section 501 (c) (9) of the bill (corresponding to sec. 101 (16) of the present code), and vice versa.

In referring to compulsory contributions into State funds, section 105 (c) should provide that such funds shall be treated "as a plan or part of a plan" of an employer, in order to permit a proper application of the key employee and 25-percent tests of section 501 (e) relating to nondiscrimination.

Much of the complications which will be involved under section 105 in many cases could be avoided simply by enacting the rule applied by the Treasury today—that employees are not taxable on medical and hospitalization insurance provided by the employer.

LOSS ON THE STOCK OF AFFILIATED CORPORATIONS

Under section 23 (g) of the present code, a loss incurred when stock in an "affiliated corporation" becomes worthless is an ordinary loss, but a loss incurred when stock in any other corporation becomes worthless is a capital loss. An "affiliated corporation" is specifically defined to include only a corporation 95 percent of whose stock is owned by the taxpayer, and more than 90 percent of whose gross income for all taxable years has been from sources other than dividends, interest, rents, and certain other investment income. The percentage of gross income requirement is of course intended to restrict the allowance of an ordinary loss to the stock of subsidiaries which have been actively engaged in business operations, as distinguished from those which have merely held investments.

Section 165 of the new code converts the percentage of gross income requirement to a percentage of gross receipts requirement, the requirement otherwise remaining the same. This change will help to take care of the situation where, under present law, the subsidiary would fail to qualify as an affiliate because its direct costs of operations have exceeded or approximated its sales, and it therefore has had little or no gross income from operations.

But there is a similar situation for which the proposed change is inadequate. For instance, in the mining industry a subsidiary is frequently organized to carry on the exploration for and the development of certain mineral deposits in a specified area. If marketable deposits are discovered, the subsidiary proceeds with the mining operation. But if they are not discovered, operations are discontinued without either gross income or gross receipts having accrued to the subsidiary in any amount whatever. Such a subsidiary has obviously had active operations, and the loss on its stock should clearly be allowed as an ordinary loss.

The necessary modification of the provision could be made simply by substituting a requirement that not more than 10 percent of the gross receipts of the subsidiary, if any, should be from investment income of the specified classes.

DEPRECIATION

The depreciation deduction provided by section 167 is undoubtedly an improvement over present law. However, it is by no means enough of an improvement to justify the tremendous attention it has received. In fact, it falls far short of the thorough overhaul our depreciation policies deserve.

The provision in section 167 (e), under which a change in the rate of depreciation cannot be made unless the useful life determined by the Government differs from that used by the taxpayer by more than 10 percent, can be characterized only as window dressing. It is so easy for the Internal Revenue Service to choose a useful life which exceeds that used by the taxpayer by more than 10 percent that section 167 (e) is hardly worth writing into the law. And note that more than a 10-percent difference is involved in a dispute between 30 years and 33⅓ years on a building and in a dispute between 9 years and 10 years on a machine. This 10-percent rule is more restrictive than the policy announced by the present Commissioner of Internal Revenue. What future Commissioner will have the nerve to stand by the present administrative policy in the face of this narrow statutory provision?

Allowance of declining balance depreciation at twice the straight-line rate is certainly advantageous in the early years of an asset's life, but it may have disastrous consequences on the depreciation deductions allowable as the asset nears the end of its useful life. Since depreciation on the declining balance method is a fixed percentage of the remaining undepreciated balance, depreciation deductions become smaller year by year. Eventually they become smaller

than those which would be allowed by applying straight-line depreciation (based on the remaining useful life) to the remaining undepreciated balance. A portion of an asset's cost will still remain undepreciated at the end of its useful life. This may or may not approximate its actual salvage value.

Section 167 (b) does not state whether a taxpayer may shift from declining balance to straight-line depreciation in a case where annual depreciation under the declining balance method has been reduced to the point where it will be inadequate to allow the recovery of the excess of remaining cost over salvage value by the end of an asset's useful life. This privilege should be expressly provided in the law. Otherwise, the declining balance method may often turn out to be a trap for unwary taxpayers.

The new provision for use of the declining balance method at twice the straight-line rate is limited to new assets, disregarding the fact that many new businesses are started with secondhand equipment and that a businessman's willingness to buy new equipment is often dependent on the price he can get for his old equipment. The limitation to new assets in section 167 (c) will knock out entirely the market for secondhand machine tools.

The privilege provided in section 167 (b) (3) of using depreciation methods other than straight-line or declining balance is largely illusory, since the aggregate deductions allowed up through the taxable year under any such other method may not exceed those permitted under the declining balance method. Since, as was pointed out above, the declining balance method may result in less aggregate depreciation after a few years than even the straight-line method this is not a suitable limitation to impose on other depreciation methods. It is difficult to see how any variation of the unit of production of machine-hour method of depreciation could be used sensibly under such a limitation and it should be stricken out.

Much more decisive changes in our depreciation policy for tax purposes are needed than those contained in section 167. This policy should be geared to the concept that our economy must expand and not merely "keep even," it should recognize the effects of changing price levels, it should take account of the increasing role of obsolescence, and it should be based on the basic principle that the purpose of deductions for depreciation is to permit the tax-free recovery of cost. Taxpayers should be permitted, at their election, to deduct 50 percent of expenditures for depreciable property in the year the expenditure is made or over a 5-year period, with the remaining 50 percent being subject to the ordinary rules for depreciation deductions. Furthermore, neither depreciation allowed nor depreciation allowable should reduce basis unless it results (or would have resulted) in a tax benefit either in the year allowed or allowable or in another year to which a loss from such year was carried back or carried forward.

AVERAGE INCOME THROUGH NET OPERATING LOSS CARRYOVER

The provisions of section 172 of the bill made considerable progress toward elimination of the inequitable adjustments required under present law in applying net operating loss carryovers. However, under the bill taxpayers will still lose in some cases the full benefit of the deduction for percentage depletion, and intercorporate dividends are still treated as fully taxable income in computing net operating losses.

The change in treatment of intercorporate dividends under section 243 whereby taxpayers are allowed a deduction equal to 85 percent of these dividends in lieu of an 85-percent credit against net income makes correction of the unfair adjustment required in computing net operating losses possible with a very simple change. All that is necessary is elimination of section 246 (b), which limits the intercorporate dividend deduction to 85 percent of taxable income. If this limitation is eliminated consistent treatment of intercorporate dividends will be provided regardless of whether they are received by the taxpayer in an income year or in a loss year.

Section 172 (d) (6) should be eliminated to permit consistent treatment of percentage depletion under the net operating loss provisions. Section 172 (d) (6) has the effect of denying the excess of percentage depletion over adjusted basis depletion in computing the loss in a loss year and in determining the adjustments to be made to a net operating loss carryover by reason of its application to other years.

NET OPERATING LOSS DEDUCTION FOR 1954

In providing for the carryover of business losses as a deduction in computing income taxes, the present code generally follows the principle of permitting such

losses to be carried forward from the 5 years immediately preceding the taxable year, and carried back from the year immediately following the taxable year. This principle was first adopted by the Revenue Act of 1950. But that act, presumably for reasons of economy, did not make the principle of a 5-year carryforward fully effective for any year prior to 1955—only a 2-year carryforward was allowed in computing the tax for 1950, 1951 and 1952, a 3-year carryforward for 1953, and a 4-year carryforward for 1954.

In its consideration of the revenue bill of 1951, the Congress recognized the anomaly of postponing until 1955 the operation of a principle approved in 1950. But it limited its corrective action at that time to the allowance of one additional loss carryforward into 1951 (a 1948 loss) and 1952 (a 1949 loss).

In section 172 of the new code, it is proposed to adopt the principle of a 2-year (instead of a 1-year) carryback, and to give effect to this principle even in the computation of the tax for 1952 and 1953.

If this action is possible, it should also be possible to make the principle of the 5-year carryforward fully effective at least for 1954.

MEDICAL EXPENSE DEDUCTION

Under section 22 (b) (5) of the present code amounts received through accident or health insurance as compensation for personal injuries or sickness are excludible from gross income. Under section 23 (x) a deduction is allowed for certain medical expenses paid during the year, but only if "not compensated for by insurance or otherwise." This condition is necessary so that a double tax benefit may not be claimed where medical expenses are paid out of the proceeds of health or accident insurance.

Section 213 of the new code continues the medical expense deduction in a form similar to that found in section 23 (x), retaining the condition that the expenses so deductible are only those "not compensated for by insurance or otherwise." But under sections 104 and 105 of the new code the benefits payable under some employee health-insurance plans are taxable to the employee. Deductions should be allowed for medical expenses which are reimbursed by such benefits, as in this situation no double tax benefit is possible.

CHILD-CARE EXPENSES

The new child-care-expense deduction provided in section 214 is so limited in scope that it can hardly be considered a solution to the problem it purports to answer. First, the deduction is not allowable if both the father and mother work. Second, the deduction is limited to $600 a year. Third, the deduction is not allowed if the taxpayer uses the optional standard deduction. Fourth, the deduction is not allowed in the usual case after the child attains the age of 10.

Failure of section 214 to cover the case where both father and mother work is apparently a result of prejudice against working wives. It ignores the fact that many wives who are mothers are forced to work because of economic necessity.

The $600 limit on the deduction is completely unrealistic in terms of the present-day cost of hiring maids or nurses. Wages for child care often range as high as $35 or $40 a week, plus carfare, or more than 3 times the maximum deduction allowable under section 214.

Failure to treat the deduction for child-care expenses as a deduction in arriving at adjusted gross income will have the effect in most cases either of making it unavailable or of reducing the $600 deduction still further by requiring the taxpayer to forego the standard deduction in order to obtain it. This will be an especial hardship on the low-income taxpayers the provision was particularly meant to help.

Children who have reached the age of 10 are not so old as to no longer need supervision, as assumed by section 214. This age limitation should be increased at least to 12 years.

DIVIDENDS RECEIVED ON CASUALTY INSURANCE COMPANY STOCK

Under present law corporations are allowed a credit against income of 85 percent of the amount of dividends received. The new code contains an equivalent allowance in the form of a deduction under section 243, and also allows to individuals a credit against tax of a percentage of dividends received (sec. 34) and a limited exclusion of dividends (sec. 116). In connection with each

of these allowances, the new code provides that it does not extend to dividends received from insurance companies.

This discrimination against the stockholders of insurance companies does not exist under the present dividends received credit. At least in the case of stock fire, and casualty companies, taxable under section 831, it is entirely illogical. These companies pay taxes at the regular corporate rate on every dollar of income, both from investment and underwriting sources. The allowances should be extended to dividends on their stock under the same conditions as on other stock.

PUBLIC-UTILITY CREDIT FOR DIVIDENDS PAID ON PREFERRED STOCK

In 1942 the Congress authorized public utilities, in computing their income subject to the corporate surtax, to offset such income by the amount of the dividends which they paid during the year on certain stock. This right was made available only in the case of stock which had been issued prior to October 1, 1942, the dividends on which were preferred over the dividends on other stock and were cumulative and limited in amount. This "credit for dividends paid," despite frequent intervening amendments of sections 13 (a), 15 (a), and 26 (h) of the Internal Revenue Code, of which the credit is a part, continues today in substantially its original form, except that it is now a partial offset against both normal and surtax net income, rather than a complete offset against the latter only. The new code would continue it without substantive change, but as a deduction rather than a credit.

The reason for the provision is obvious from its terms. Prior to 1942 many public utilities, unable to foresee the extraordinary wartime corporate-tax increases, had elected to finance additions and betterments through the issuance of large amounts of cumulative preferred stock. Unlike interest on bonds, the dividends on such stock were not deductible for Federal income-tax purposes. Nevertheless these dividend charges, equally as much as bond interest, had to be met each year unless unpaid accumulations were to be permitted to destroy the capacity of the issuing corporation to obtain funds for subsequent expansion and even, during an inflationary period, the capacity to make replacements.

But in one respect the terms of the law providing the credit were drafted without a full appreciation of the situation for which relief was required. Under section 26 (h) the credit was allowed only for preferred stock dividends paid by a "public utility," and a "public utility" was defined to mean only a corporation which is itself engaged in the "sale" of utility services. Thus, even where consolidated returns were filed by several utility corporations, the credit was denied unless the same corporate entity which was directly obligated to pay the dividends was also the corporation engaged in the "sale" of services. Actually, of course, a single public utility operation is often carried on by two or more corporate entities acting in concert, each having a function complementary to that of the other. For instance, a parent corporation may be used to hold title to utility properties and to lease them to a wholly owned subsidiary corporation, and the wholly owned subsidiary to operate the properties and to deal directly with consumers. In such situations capital for the enterprise is usually raised by a different corporate entity from the one which markets the services. To deny the section 26 (h) credit for this reason was probably not intended, and certainly results in an arbitrary discrimination against affiliated groups.

The bill should be amended to do away with this discrimination in the majority of such cases by extending the credit to any corporation which is the parent of one or more subsidiaries which are engaged in selling utility services (i. e., of subsidiaries which are public utilities as presently defined in the law), assuming, of course, that the parent has outstanding cumulative preferred stock issued prior to 1942. This extension of the credit should be carefully limited, however, by requiring that any such parent corporation should bear the same close degree of relationship to such subsidiaries as exists between corporations entitled to file a single consolidated return, and further by requiring that at least 80 percent of the parent's gross income be paid to it by such subsidiaries in the form of dividends, interest, or rents. These limitations would insure that the credit will not be made available except with respect to preferred stock which served as a medium of financing the acquisition of public utility properties, and stock which still represents an obligation of an integral part of an operating utility system.

Even though cases may be found where both such a parent and such a subsidiary have pre-1942 preferred stock outstanding, and part of the subsidiary's

preferred is held by the parent, there is no possibility under the amendment of any doubling up of the credit. In any such case section 244 of the bill intervenes to offset the dividends paid credit allowed to the subsidiary by a reduction in the amount of the dividends received credit otherwise allowed to the parent. Thus a parent and a subsidiary which had been partially capitalized through the issuance of preferred stock by the parent would, together, be treated substantially the same under the amendment as would an individual public utility corporation which had issued its own preferred stock, regardless of the form of the transaction in which the parent in the former case had transferred capital to the subsidiary.

Generally such an amendment should be applicable only to 1954 and subsequent years. But wherever a parent utility corporation claimed the dividends paid credit on its return, the amendment should be given effect all the way back to 1942, insofar as possible without the authorization of refunds. There are several reasons for this limited retroactive application. Cases have been reported in which the Government has threatened a double exaction of taxes by denying a dividends paid credit to a parent utility corporation, while it was simultaneously collecting (or claiming) a tax from an incorporated preferred stockholder in the parent computed without regard to the dividends received credit on the same dividends, although under the law either the one credit was allowable to the payor or the other was allowable to the payee without question. This practice is actually attributable to the difficulty of determining whether the parent was selling utility services, or whether its status was rather that of a licensor, lessor, creditor, or stockholder of its subsidiary. The proposed retroactive application of the amendment would remove the source of this confusion and preclude any such double collection of taxes. Furthermore, the stock on which the credit is allowable must have been issued in 1942 or a prior year, and the failure on the part of the Congress to grant the credit to such parent corporations in 1942 was very likely an oversight.

INTEREST DEDUCTION ON HYBRID SECURITIES

Under present law it is established that a security may actually represent an equity investment in a business, even though denominated a "bond," "income bond," "debenture," or "income debenture." Where on all the facts it appears to represent an equity investment rather than a loan, the interest payable thereon is held nondeductible, and generally the security is treated as stock rather than an indebtedness.

In an attempt to apply to this problem an easily applicable rule, sections 275 and 312 (c) of the new code propose to disallow a deduction for any so-called interest unless (i) the payment of it is "not dependent in amount upon the earnings of the corporation" and it is "unconditionally payable not later than the maturity date of the principal," and (ii) where the securities are held by owners of a substantial part of the common stock, unless the principal is not subordinated to the claims of trade creditors generally.

It should be made clear in section 312 (c) that the first of these conditions is met as to any specified amount of interest which is unconditionally payable at maturity, even though the liability to pay such amount at an earlier date or dates is dependent upon the earnings of the corporation.

It should also be provided that where interest is to be disallowed by reason of these requirements, the obligees should be entitled to the dividend allowances provided for stockholders by sections 34, 116, and 243 of the new code.

Finally, the disallowance of interest under sections 275 and 312 (c) should not be applied to securities heretofore issued. They should continue to be treated as under existing law.

STOCK REDEMPTIONS

A recurrent problem under the Federal income-tax laws has been when to tax corporate distributions in redemption of stock at ordinary income-tax rates as disguised dividends, rather than at capital gains rates as bona fide redemptions. The statutory answer to this problem, as expressed in section 115 (g) of the present code and predecessor provisions, has been that if a redemption of stock is "essentially equivalent to the distribution of a taxable dividend", it should be so taxed. The courts have been permitted to examine all the facts of each case in reaching a determination.

The new code would adopt a contrary approach. First, every redemption would be treated as a dividend unless it met one of certain prescribed conditions; and second, the conditions by which dividend treatment might be avoided are defined in mathematical terms. The consequences are that a conclusive presumption of "dividend equivalence" would be attached to many bona fide redemptions, while in a variety of undeserving situations the way would be paved for easy tax avoidance.

For instance, section 302 of the new code provides that if preferred stock is redeemed from a stockholder who owns 1 percent or more of the common stock, the entire amount which he receives in redemption of the preferred is to be included in his income and taxed to him as a dividend. It is immaterial whether he had paid face amount for the preferred, whether he had bought it from the corporation or from another stockholder, and how long he had held the preferred or how long he had held the common. The result in many cases would be a virtual confiscation of a stockholder's capital investment. Where a minority holder of common stock has made a substantial amount of funds available to the corporation for a callable preferred, this provision would also put him at the mercy of a hostile majority stockholder.

On the other hand, even where all of the common and all of the preferred of a corporation are held by the same individual, the dividend tax on a redemption could be avoided under section 302 simply by the expedient of a sale of the preferred (or the part of it to be redeemed) to a third party shortly before the redemption is effected. Furthermore, section 302 guarantees capital gain treatment upon redemptions from the holders of less than 1 percent of the common stock of a corporation, even though the distribution is in redemption of common stock on a strictly proportionate basis and there is no simultaneous contraction of the business of the corporation.

As the Congress has recognized for the past 33 years, this problem is one where mathematical solutions are entirely impracticable. Section 302 should be deleted from the bill, and the general test of section 115 (g) of the present code substituted for it.

PURCHASE BY PARENT OF STOCK IN SUBSIDIARY

Section 115 (g) (2) of the present code provides that a sale by a stockholder of A corporation of stock of A corporation to B corporation, where B is a subsidiary of A, may be treated as a redemption of such stock by A itself for purposes of considering whether the transaction is essentially equivalent to a dividend from A to its stockholder. Section 304 of the new code would add to this a provision that if the stockholder also owns some stock in B (the subsidiary), and if he sells this stock to A (the parent), this would also be so treated under certain circumstances.

Section 115 (g) (2) relates to a peculiar transaction which can probably have no purpose other than tax avoidance. The other transactions to which section 304 relate frequently have a sound business purpose, such as the consolidation of the control of one corporation over another, or the elimination of minority interests in subsidiary corporations. There is no more reason to tax as a dividend amounts which a stockholder receives from his corporation upon a redemption of stock of a subsidiary than amounts received for diversified stocks, or any other kind of property sold to the corporation.

The extension of section 115 (g) (2) which is proposed by section 304 was proposed by the Treasury in 1950, and the Congress rejected it. The reasons for the extension are no better today than they were in 1950.

PREFERRED STOCK "BAILOUTS"

Section 309 of the new code imposes upon corporations which redeem preferred stock issued as a dividend or in a recapitalization, where the redemption is effected either within 10 years of the date the stock was issued or prior to January 1, 1964, a "transfer tax" equal to 85 percent of the redemption price.

The purpose of the transfer tax is frankly to penalize all such redemptions simply because a case has been reported in which the controlling stockholder of a closely held corporation caused the corporation to issue a preferred stock dividend, and the dividend stock was immediately sold and redeemed a short time later, all as a part of a plan to avoid the tax which would have been payable by the stockholder on a cash dividend. Section 309 is a grossly unfair solution of the problem:

(*a*) Tax avoidance, where it occurs in this situation, is at the shareholder rather than the corporate level, and the penalty should fall at the shareholder level. Otherwise minority shareholders will be penalized for redemptions for which they are not responsible and from which they get no benefit.

(*b*) Many preferred stocks issued many years ago are presently being redeemed pursuant to sinking fund arrangements which are expected to continue to operate for many years in the future. These arrangements are in some instances embodied in the corporate charter, and cannot be changed. The ownership of the corporation may have changed hands completely since the alleged shareholder avoidance occurred. Application of the tax to such previously outstanding preferreds with existing sinking fund provisions is inexcusable.

(*c*) Even if the policy embodied in section 309 were sound, there would be no reason for penalizing redemptions occurring prior to 1964, where the stock was issued more than 10 years prior to the date of the redemption.

For several years the Treasury has taken the position that a stockholder would realize ordinary income upon a sale of preferred, if the issuance, sale, and redemption were all parts of an integrated plan. This should be the rule both as to preferred and as to common. If it is not believed that this position can be defended under the present code, it should be enacted into law, and the section 309 tax should be abandoned.

This suggestion is preferable to the American Law Institute proposal that the proceeds of a sale of preferred stock issued as a dividend or in a recapitalization should be taxed as a dividend in all events. There should be no penalty on the sale of such preferred. So long as this stock remains outstanding it represents a claim on the earnings of the corporation basically similar to the claim of common stock. The head of a family business who has reached an advanced age, and who is required to sell part of his business in order to remain liquid, should not be forced to divide the control of the business by selling common rather than preferred, nor should he be compelled to sell out altogether to his bigger competitors. Often the only way that this can be avoided is for preferred to be issued and sold. If at some future date this preferred is redeemed—not according to a preconceived plan—this is no worse than if the common stock of certain stockholders is redeemed.

LIQUIDATION OF SUBSIDIARIES

Part II of subchapter C of the income-tax provisions of the new code adopts an entirely new approach for corporate liquidations. As applied to a parent corporation's liquidation of its subsidiary, the usual result under part II would be—

(*a*) if the parent's basis in the subsidiary's stock is exceeded both by (i) the value of the subsidiary's assets and (ii) the subsidiary's basis in its assets, no tax upon the liquidation, and the parent will take over the asset at a steppedup basis equal to the lesser of (i) and (ii);

(*b*) if the parent's basis in the subsidiary's stock is exceeded by the value of the subsidiary's assets but not by the subsidiary's basis in its assets, no tax upon the liquidation, and the parent will take over the assets at an aggregate basis equal to its basis in the subsidiary's stock; and

(*c*) if the parent's basis in the subsidiary's stock exceeds the value of the subsidiary's assets, loss will be recognized to the parent, and the parent will take over the assets at a basis equal to their value.

In many situations these provisions are more liberal than present law as embodied in sections 112 (b) (6) and 113 (a) (15) of the code. But this greater liberality will be enjoyed at the cost of having to procure an appraisal of all of the assets of a liquidated subsidiary, and of extended valuation controversies with the Government. Sections 112 (b) (6) and 113 (a) (15) were enacted almost 20 years ago for the very purpose of avoiding these valuation problems. Furthermore, where the value of the subsidiary's assets is less than the subsidiary's basis in such assets and less than the parent's basis in the stock, the parent's capital loss will be enjoyed at the cost of a lower basis in assets which may include inventory and depreciable property.

The new code should continue to make the provisions of sections 112 (b) (6) and 113 (a) (15) available in the future wherever the parent corporation, in liquidating a subsidiary, elects to forego the higher basis or the immediate recognition of loss which it would otherwise enjoy under part II in its present form.

LIQUIDATION OF COLLAPSIBLES

Subchapter C of the income-tax provisions of the new code contains several provisions (in sec. 302 (a) and (b), 331 (d), 333 (c), 334 (d), and 336 (d) and (e)) relating to the distribution of inventory items and certain other assets in redemption of stock. These are apparently aimed at the so-called collapsible-corporation problem, and the collapsible-corporation provisions of the present code are discarded.

For the purposes of these several provisions section 336 (d) defines "inventory assets" to include not only property of a kind ordinarily includible in inventory, but also property held for sale to customers, certain unrealized rights to income, and land and depreciable property used in the business and held less than 5 years.

Sections 302 (a) and (b) provide that a distribution of inventory assets in redemption of all of the stock of a particular stockholder, or in a redemption which is substantially disproportionate (i. e., reduces by more than 20 percent the proportionate common stock interest of a particular stockholder), shall be taxed to the recipient as a dividend. The full value of the distributed property will be included in the distributee's gross income (to the extent of earnings and profits), and his basis in the stock redemmed will be lost.

This is a grossly harsh and inequitable measure, even if the purpose is to prevent the conversion of ordinary gain into capital gain in certain cases. In many cases, the potential gain on the assets distributed (e. g., land and depreciable property) will not be ordinary gain. In others there will be no potential gain of any kind, as the assets in question will not have appreciated in value in the hands of the corporation. In neither of these two latter classes of cases is the provision in question justified in any respect. In other cases, where there is a potential ordinary gain, it would be sufficient to adopt an approach similar to that used for liquidations, imposing upon the stockholder a basis in the "inventory assets" no greater than the corporation's basis, and computing gain or loss accordingly.

DEFINITION OF LIQUIDATIONS

While generally providing appropriate treatment for transactions qualifying as liquidations, part II of subchapter C of the income tax provisions of the new code is extremely restrictive in defining what may qualify for this purpose. None of the following types of transactions, all of which qualify as liquidations under the present code, would qualify as liquidations under section 336 of the new code:

(*a*) A redemption of all of the stock of a particular stockholder. For instance, X owns only preferred stock of a corporation, and upon the termination of certain business operations the assets used in connection with such operations are distributed in liquidation of the preferred stock. The distribution to X would not qualify as a distribution in partial liquidation.

(*b*) A redemption which is "substantially disproportionate" within the meaning of section 302 (a) (4), i. e., which reduces the stockholder's proportionate interest in the common stock of the corporation by more than 20 percent. For instance, X, Y, and Z each own one-third of the common stock of a corporation. It discontinues an operation, and prepares to dispose of inventory, machinery, and other equipment worth $50,000 and a building worth $37,000. It is agreed that rather than selling these assets and distributing the proceeds, the inventory, machinery, and equipment will be divided equally between X and Y in liquidation of one-half the stock of each, and the plant will be transferred to Z in liquidation of three-fourths of his stock. This may be a partial liquidation as to X and Y, but not as to Z.

(*c*) A redemption of part of the stock of a corporation pursuant to the termination of a business operated less than 5 years. For instance, 3 years ago the stockholders decided that the corporation should embark on a new operation. They made proportionate contributions of the necessary capital in exchange for additional stock, and put a plant into operation. This year (the new code having gone into effect) it becomes apparent that the new operation is a failure. The assets used in connection with it are sold, and the proceeds refunded to the stockholders in redemption of the additional stock. This distribution would not qualify as a partial liquidation. On the other hand, to the extent of the undistributed earnings of the corporation accrued from its regular business operations, it would be treated as a taxable dividend.

(*d*) A redemption of part of the stock of a corporation pursuant to the termination of a business whose cost of goods sold during any one of the preceding 5 years exceeded its net sales, or of a business which in any one

of the 5 preceding years had a negligible amount of gross income and some investment income.

(*e*) A series of distributions over a period of 4 years in redemption of all of the stock of a corporation, the corporation having continued the conduct of its business during such period. For instance, a corporation is engaged as a public utility in the generation of electric power and its sale in a number of communities. Because these communities desire to own and operate their own distributing systems, the corporation decides to sell all of its facilities and undergo a complete liquidation. From the date of the first sale, negotiations for the sale of the other systems are constantly in process but they drag out over a period of 4 years. It is of course required by law to continue operations in the meantime. Distributions of the proceeds of the several sales would not be considered to be distributions in liquidation. They would be considered to be dividends to the extent of the undistributed profits of the corporation.

The only avowed purpose of the provisions of section 336, as illustrated above, is to insure that a liquidation constitutes the termination of a separate business enterprise, and not the mere contraction of a unitary business. Assuming that this distinction has some validity from a practical standpoint, the requirements of section 336 go much beyond the objective. For more than a generation under the Federal income tax laws the courts have had the problem of what constitutes a liquidation, and it is not apparent that they have failed to handle it in a satisfactory manner without the assistance of mathematical rules, which necessarily produce inequities in many situations.

The provisions of section 336 (a) and (b) defining partial and complete liquidations should be eliminated, and the provisions of the present code on this subject should be continued.

SPLIT-OFF REORGANIZATIONS

Under the present code the assets of a corporation carrying on 2 or more business operations may be divided between 2 or more corporations (including the existing corporation) without taxable gain or loss at the time of the division. This may be done as a "split-up" or "split-off" reorganization under sections 112 (b) (3) and (4) and 112 (g) (1) (D) of the code, or as a "spin-off" reorganization under sections 112 (b) (11) and 112 (g) (1) (D). Under the court decisions "split-ups" and "split-offs" are valid reorganizations only if carried out with an adequate "business purpose." In the case of "spin-offs" the statute expressly provides that gain shall be recognized to the distributee of the stock of the new corporation if it appears that one of the corporations was not intended to continue the active conduct of a trade or business after the reorganization, or that the transaction was used principally as a device for distributing earnings of one of the corporations.

In general the new code continues to recognize 'split-up", "split-off", and "spin-off" reorganizations as tax free, but adopts a new approach to this subject which, under the guise of substituting tangible rules for the more general tax avoidance standards mentioned in the preceding paragraph, will block many desirable reorganizations and lead to confusion with respect to many others.

The approach of the new code, as embodied in section 353, is that reorganizations of this character may proceed without restriction if none of the corporations involved is an "inactive corporation." If one of the corporations is an "inactive corporation," any amounts realized upon the stock of such corporation within 10 years from the date of the reorganization would be taxed to the recipient in full as ordinary income, and if such amount was realized upon a sale or redemption, the basis of the stock sold or redeemed would be lost. The practical consequence is that this type of reorganization becomes impossible (particularly in the case of a widely-held corporation) if one of the corporations involved falls within the statutory definition of an "inactive corporation."

Although the language of section 353 is not entirely clear on this point, it seems that a corporation would be conclusively deemed to be an "inactive corporation" if it chooses to carry on its business through subsidiary corporations rather than through unincorporated divisions. For instance, X corporation is engaged in the business of producing motion pictures and operating motion picture theaters. Pursuant to an antitrust decree, it proposes to transfer the theater properties to a new corporation, the stock of which will be distributed to its stockholders, thus divorcing the ownership and management of the two businesses. The theater properties are held and operated through a number of subsidiary corporations. It appears that the divorcement, which clearly may be

carried out under present law without taxable gain or loss, would result under section 353 in the taxation to the stockholders of the entire amount realized upon a sale of the stock of the new theater company at any time within the succeeding 10 years.

The definition of an "inactive corporation" also includes any corporation whose business during the 5 years preceding the reorganization failed to return any gross income, or returned gross income in a negligible amount, there being some investment income during the same year.

Section 353 of the new code should be amended to eliminate the novel concept of an "inactive corporation," and the harsh and inequitable penalty imposed upon the stockholders where such a corporation is found to exist. In lieu of the "inactive corporation" concept, the tax avoidance standards written into section 112 (b) (11) of the present code should be continued. If the "inactive corporation" concept is retained, it should be clarified to insure that it will not attach to any bona fide business operations.

TAX-FREE DISTRIBUTION OF SECURITIES

Corporations often find that, for sound business reasons, they should divest themselves of stock or securities in other corporations, but the tax consequences prevent them from either selling these securities or distributing them to their shareholders. While section 353 of the bill corrects this problem in some situations, it is designed to prevent the tax-free distribution of securities which do not represent control of active businesses. Thus this section is not helpful where a corporation wishes merely to divest itself of investments which are no longer appropriate.

The tax system should be designed to facilitate the divestiture of such securities, rather than to make it impossible. Of course, a provision permitting this would have to have adequate safeguards to prevent the mere purchase and distribution of securities to avoid dividend tax. Accordingly, it is recommended that distributions by a corporation of stock or securities of other corporations be permitted tax-free if such stock or securities have been held for at least 20 years. The basis of such securities in the hands of the distributees should be an allocable portion of the basis to them of the stock of the distributing corporation.

THE 20–80 RULE IN REORGANIZATIONS

Under the present code 2 corporations may combine, or 1 may acquire the other, in any 1 of several ways which will qualify as a tax-free reorganization—(a) by a statutory merger or consolidation, (b) by an acquisition by 1 corporation, in exchange for some of its voting stock, of 80 percent of the stock of another corporation, or (c) by an acquisition by 1 corporation, in exchange for some of its voting stock, of substantially all the properties of another corporation. Provisions to this effect have been in the income tax law since 1921. At no time has the size, or the relative size, of the two corporations been considered material.

Under section 359 and related provisions of the new code these transactions would continue to be tax free, but only if neither of the two corporations is more than four times as large as the other. This condition has been referred to as the 20–80 rule, because under it at least 20 percent, and not more than 80 percent, of the stock of the continuing corporation must be held immediately after the reorganization by the persons who before the reorganization were the stockholders of each of the preexisting corporations.

Curiously enough, where a reorganization involving two publicly held corporations is carried out in the form of a statutory merger or consolidation, section 354 of the new code provides that the 20–80 rule shall not apply.

The purpose of the 20–80 rule is not explained in the report of the Ways and Means Committee. It could hardly be to tighten up the old continuity-of-interest rule, as the new code relaxes that rule in other areas, such as split-offs.

The 20–80 rule should be scrapped, and mergers and other corporate amalgamations should be recognized as tax free without regard to whether the corporations are publicly or privately held, the form that the reorganization takes, or the relative size of the corporations involved.

EFFECTIVE DATE OF REORGANIZATION PROVISIONS

Under section 391 of the new code, the new reorganization provisions are made effective, generally, with respect to distributions or transfers occurring after March 1, 1954.

Several of the new reorganization provisions which tighten up the law on when gain will be recognized—notably the inactive-corporation concept of section 353 and the 20–80 rule of section 359 (b) and (c)—were not publicly announced until the introduction of the bill in the House on March 9. Consequently, it is extremely inequitable to employ an effective date prior to March 9.

The problem of the effective date of these provisions goes much beyond that, however. Many reorganizations had been planned, agreed to, approved by directors and stockholders, and even held to be nontaxable by Treasury closing agreements, all prior to March 9, with only the transfer of assets and exchanges of stock to take place after that date. The bill should obviously provide an adequate opportunity for these transactions to be consummated tax free, if they would be tax free under current law. Where a Treasury closing agreement has been issued, the status of the reorganization should be governed by it if it would be applicable except for the new code, even though the reorganization is not fully consummated until some time in 1955 or 1956.

EXECUTIVE COMPENSATION PLANS

Section 401 of the new code confirms the rule that a deferred payment of compensation by an employer directly to an employee is taxable to the employee when received. But the new code goes much further on this general subject. Recognizing the wisdom of the policy underlying the rule just stated, sections 401 and 402 further provide that employees for whom employers purchase annuities or set up trusts shall be taxed only as the annuity payments or the trust distributions are received. It is immaterial whether the plans are qualified or not. These provisions signal the end of an era of folly in which the Treasury threatened (successfully, in some cases) to require employees to pay taxes on compensation under nonqualified plans which would not become actually available to them for several years in the future.

Unfortunately, the new code does not deal with the employer's deduction for such compensation with the same logic or the same success. Where the plan is nonqualified, section 403 declares that the employer may deduct the amount of his disbursement only as and when received by the employee, not at an earlier date on which the employer may have purchased an annuity for the employee, deposited funds in a trust for his benefit, or accrued a fixed liability on his books. This provision is a major deficiency in the new code, and there are several reasons why it is wrong.

(1) The principal reason for postpoining the employer's deduction for deferred compensation paid under nonqualified plans is that these plans may have the effect of reducing the employee's income taxes below what they would have been if the compensation were paid currently, and it is suggested that such plans should therefore be discouraged. Actually, postponing the tax on the employee until the compensation is received may or may not reduce the overall amount of his taxes. For many taxpayers, for instance, a postponement of income for tax reasons from the late 1940's to the early 1950's would have had an effect contrary to that desired. Similarly, postponing the employer's deduction may or may not reduce the overall amount of his taxes.

(2) Whether or not postponement of the employer's deduction can be relied upon to increase his tax liability, it will have the intended effect of discouraging executive compensation plans because it will produce a gross distortion of income. The interval between the actual accrual of the obligation to pay such compensation, or its payment to a trust or an insurance company, and its receipt by the employee may be 5, 10, or 15 years, or even longer. Few firms can afford to incur relatively large obligations in respect of current operations which cannot be charged against current income, but must be held in suspense for such a substantial period. Of course if obligations under such a plan were incurred today, and the deductions should become allowable in a future year when both profits and taxes are higher than today because of another war, the net result of the postponement would be that the employer would enjoy a windfall. But on the other hand, if the future year were one in which the employer has no profits, the benefit of the deduction might be lost altogether. At a time when the Congress is adopting many wise changes in the direction of synchronizing tax accounting with sound business accounting generally, it is anomalous that it should offset their effect with this required distortion of income.

(3) Profit sharing, retirement, and other incentive compensation plans deferring compensation to management have a recognized and a necessary place in the modern business organization. They are not simply tax devices. Executive

employees as well as labor face the financial problems of compulsory early retirement. Executives are especially interested in profit sharing and other contingent compensation plans where their returns will be based upon the results achieved. Business, if it is to secure vigorous, progressive, and venturesome direction, must be allowed to adopt effective incentive compensation plans.

(4) Finally, it is doubtful that the scheme by which the deduction is deferred is workable in any event:

(*a*) Section 403 does not indicate what happens to the deduction if the identity of the employer is destroyed o raltered before the deduction is allowed. For instance, suppose a corporation which has purchased annuities for employees over a period of years sells its assets and liquidates before the annuities have been paid. In its present form, the bill would allow no deduction. Even if the deduction were then to be allowed in the year of liquidation, the bunching which would result would probably deprive it of any value. Similar problems would arise upon the death of an individual employer, and upon changes in the membership of a partnership employer.

(*b*) The Ways and Means Committee report states that the deduction would be limited to the amount of distributions which represent employer contributions. It is not clear how this is to be determined even in the case of the first distributions from a trust or the first payments of an annuity. Part of such distributions or payments might be considered to represent earnings on principal. No rule is provided by which to allocate. Nor is any rule provided with respect to the premature death of an annuitant.

(*c*) Union-negotiated, industry-wide pension plans have become prevalent in recent years. Many of these are not qualified and would not qualify under the bill. Under most of them it will be difficult, and under some impossible, to relate distributions to former employees in the industry to the contributions of specific employers.

(*d*) No rule is provided covering sales or gifts by an employee of rights to deferred compensation, nor is any suggestion made as to the manner in which employers can learn of such events if they are to be material to the employer's tax liability.

(*e*) Even in the absence of such a sale or gift, it is undesirable to place on employers the burden of computing their income by reference to transactions which are not reflected on their books, and to which they are not parties.

The only practical solution, and the only proper solution, is that employers should be allowed and required, in all cases, to follow their regular accounting practices with respect to deductions for deferred executive compensation, as with other deductions. If there is to be any departure from this rule, it should in no event go further than to postpone the deduction until the time the employer has actually made an irrevocable payment to a trust, for example, or to an insurance company which issues an annuity contract.

DEDUCTIONS FOR CONTRIBUTIONS TO PENSION PLANS UNDER CONSOLIDATED RETURNS

Under the present law limitations on deductions for contributions to qualified employee pension plans are applied separately for each corporation in an affiliated group, even though consolidated returns are filed. This rule conflicts with the compensation setup frequently found in affiliated groups in that the higher paid, top executives tend to be concentrated in the parent corporation (which is in keeping with the overall management function of the parent corporation). The result has been the imposition of unfair limitations under section 23 (p) (1) (A) of the 1939 code, and undoubtedly similar inequities will arise in applying the limitations contained in section 403 (a) of the bill.

Affiliated groups should be allowed to apply limitations on the deduction of contributions to employee pension plans on a consolidated basis.

SECTION 117 (p) OF THE INTERNAL REVENUE CODE OF 1939

The Revenue Act of 1951 added section 117 (p) to the Internal Revenue Code to provide for capital-gain treatment to an employee of amounts received in a lump sum from his employer for release of contractual rights to receive (after termination of the employment and over a period of not less than 5 years) a percentage of future profits or receipts of the employer. Section 117 (p) applies only if the taxpayer was employed by his employer for more than 20 years and if the employment contract for at least 12 years provided for such payment of future profits or receipts. The capital-gain treatment was allowed

by section 117 (p) to avoid the unduly harsh result which would follow if the lump-sum payment were to be treated as ordinary income, subject to the high surtax brackets which would be reached by the bunching in 1 year of a large amount of income.

H. R. 8300 fails to include provisions corresponding to section 117 (p) of the existing code. No explanation of the omission is contained in the Ways and Means Committee report, and it is believed that the omission was inadvertent. In any event, the bill should incorporate the existing provisions of section 117 (p).

In addition, the provision should be extended to cover cases where the taxpayer has rendered personal services under an agency contract which similarly provides for the payment, after termination of the agency contract, of a percentage of the future profits or receipts of the principal. In such cases the personal service relationship exists, but the taxpayer may not occupy the status of an employee under the common law concepts. If an agent who has performed personal services under an agency contract is able to meet the 20- and 12-year tests of section 117 (p), there is no reason why the tax treatment provided in section 117 (p) should not apply to amounts received, upon termination of the contract, as a lump-sum settlement of the right to receive future profits or receipts of the principal.

LONG-TERM STOCK OPTIONS

Section 421 of the new code would continue substantially the same scheme for the treatment of certain employee stock options as is found in section 130A of the present code. But in one respect the provisions of the new code are more stringent. They require, in order for an option to qualify as a restricted stock option, that by its terms it be exercisable for a period of no more than 10 years. This 10-year limitation, which is not a part of the present code, is made applicable to options granted after December 31, 1953.

The unfairness of applying the 10-year limitation to plans adopted or options granted prior to the date of approval of the new code may be illustrated by the facts of an actual case. In this case the management of a corporation developed late in 1953 a stock option plan under which options would be issued for periods of 10 years and 3 months. This plan clearly qualifies as a restricted stock option plan under existing law. In January 1954 the Board of Directors approved the plan, and the SEC approved the proxy statement outlining the provisions of the plan in detail. The plan was finally approved by the stockholders of the corporation on March 15, 1954. A number of options were granted under the plan on the following day. This was 7 days after H. R. 8300 had been reported by the Ways and Means Committee, and before the management of the corporation had learned of the proposed 10-year limitation.

It is obviously indefensible to apply the new limitation under such circumstances. It is no answer to say that the plan may be amended, and that under section 421 (e) the options already granted may be reduced to 10 years without disqualification. The necessary changes may be impossible to effect, and would at a minimum involve considerable delay and expense in order to obtain the necessary stockholder approval.

The 10-year limitation should not be applied either to options granted prior to the date of enactment of the bill, or to options granted under plans approved by stockholders prior to such date.

ACCRUAL OF REAL PROPERTY TAXES

Under present law a deduction for real property taxes is allowable to an accrual basis taxpayer in the taxable period in which falls the assessment or lien date of the real property taxes. Section 461 (c) of the new code proposes to change this rule so that such taxes will be allowable to accrual basis taxpayers ratably over the period to which they relate.

The new rule is probably desirable in some situations, as where it is important that some part of such taxes should be deductible in a short income-tax period which does not include the lien date of the real property tax. But it is not desirable that the new rule should be made mandatory:

(1) The lien date usually occurs early in the period to which the real property tax relates, and sometimes in advance of such period. When the tax has become an unconditional obligation, the taxpayer should be allowed, under general principles of accrual, to take it into account if he so desires. If not permitted to do so, the anomalous result is reached of requiring an accrual basis taxpayer

to postpone his deduction beyond the time at which it would be allowed to a cash basis taxpayer.

(2) The new rule grossly distorts income for the year of the transition. For instance, if the lien date is December 1, and the tax relates to the following calendar year, a taxpayer using the calendar year for income-tax purposes will be denied a deduction for real property taxes in 1954.

The solution is simply to provide that the new method of accrual of real property taxes defined in section 461 (c) shall be elective, as is provided with respect to the new methods for treating prepaid income and reserves for estimated expenses.

COVERAGE OF PENSION AND PROFIT-SHARING PLANS

Section 501 (e) takes a laudable step in the direction of making the antidiscrimination rules for employee pension and profit-sharing plans both more definite and more liberal so far as coverage is concerned.

In providing that no plan of an employer with forty or more regular employees shall be considered discriminatory as to coverage if at least 25 percent of such employees are participants, and that no plan shall be considered discriminatory of no more than 10 percent of the participants are key employees, the new code lays down fairly reasonable standards which will permit a large proportion of these plans to establish their qualification with certainty and without the necessity of an Internal Revenue ruling. But as in the case of most mathematical standards, there are many situations which these standards do not properly fit, and for which some other provision must be made.

First, there is the situation of plans qualified under present law, which the Treasury Department has held to be nondiscriminatory, but which do not meet these mathematical standards. Section 403 (c) provides that such plans shall remain qualified in the future. But it makes no provision for instances where from time to time it will become necessary to amend pre-1954 plans in a manner which normally would have no effect on their qualification under section 165 (a) of the present code, or on their failure to qualify under section 501 (e) of the new code. It is of course impossible to define the types of amendments which should, and those which should not, be considered so important as to require a pre-1954 plan to forfeit its right to qualify under the 1939 code. Probably the best solution of this problem is to continue to permit any plan, whether established before or after 1954, to qualify if it covers salaried employees or any other classification which the Commissioner finds not to be discriminatory, whether or not it meets the mathematical standards of section 501 (e).

Second, there is the situation of employers who in the future will wish to establish plans covering salaried employees (or some other appropriate classification), where such employees constitute less than 25 percent of all of the employer's regular employees. The limitation of a plan to salaried employees may not be wholly voluntary on the part of the employer. Where his wage employees are organized and have their own pension plan, it may be entirely impracticable to cover the salaried employees under the same or a similar plan. This situation could be met by the same solution proposed in the preceding paragraph—merely to continue the provisions of existing law whereby the coverage of salaried employees, or of any other classification which the Commissioner finds not to be discriminatory, permits a plan to be qualified.

Finally, there is a situation which could best be met by an amendment to the mathematical standards as set out in the bill—that of a business which is carried on through a number of departments, each of which is separately incorporated. The number of employees in each of the departments may represent a very small fraction of the number employed in the business as a whole. It would obviously be inequitable to require that the key employee or the 25-percent test be met with respect to the employees of each incorporated department considered separately. Furthermore, such a requirement would make it possible for a business concern to set up a discriminatory plan by organizing a management corporation of which only its executives are employees. For purposes of these tests, section 501 (e) should provide that all of the employees of affiliated corporations (as defined for consolidated return purposes) shall be considered to be the employees of one employer. Elsewhere in this statement it is recommended that they should also be so considered for purposes of computing the limitations under section 403 on the amount of the employer's deduction.

BENEFITS UNDER PENSION AND PROFIT-SHARING PLANS

Section 501 (e) also attempts to establish mathematical standards for determining discrimination in contributions and benefits under employee pension and profit-sharing plans. If this attempt is successful, it too will reduce the administrative burden on the Government and the expense to the taxpayer which results under present law from the necessity of having each plan reviewed separately.

It is obvious, however, that the standards set out in the bill are inadequate for this purpose. For pension plans, this standard is simply that either the contributions or the benefits shall not bear a higher ratio to compensation for one covered employee than for any other covered employee whose compensation is lower. For profit-sharing plans there is a similar standard, except that 25 percent of the employer's contributions each year may be allocated in any other manner within certain prescribed limits.

These standards, if made applicable to existing plans, might disqualify a large proportion of them. They would deny qualification to (a) many plans which provide for credit for past service, (b) many plans which grant extra credit for length of service, and (c) many thrift plans, under which employees are permitted to contribute a varying proportion, within limits, of their compensation, which the employer undertakes to match with contributions of his own.

In the case of profit-sharing plans these problems can probably be met by allowing the employer to allocate in his discretion a somewhat larger proportion of his contributions than 25 percent. In the case of pension plans, it will be necessary either to make specific provision for weighting for length of service and other factors, or else to continue the provisions of the present code that a plan may qualify if the contributions or benefits do not actually discriminate, whether or not qualification as to contributions and benefits is established automatically by reference to the mathematical standards.

In the case of profit-sharing plans as well as pension plans, it should be possible to disregard the first $4,000 of annual compensation in applying the mathematical standards. Profit-sharing plans are frequently established as a means of providing retirement income, even though not in an actuarially determinable amount, and this fact should be recognized in allowing an offset for social security benefits in one case as well as the other.

Finally, for purposes of determining whether discrimination exists, the total compensation to be taken into account should not be limited to that paid under a definite formula. A large proportion of the current compensation of executives is frequently paid in the form of discretionary bonuses. If these are ignored, the result will be a grossly distorted picture of their compensation standard.

EMPLOYEE TRUST INVESTMENTS

The present code contains no explicit requirements with respect to the investments of exempt pension or profit-sharing trusts. It requires only that such trusts be operated for the exclusive benefit of the employees, in respect of trust investments as well as otherwise. The proper concern of the Treasury Department has been with cases where trusts have concentrated their investments in the securities of the employer—as to whether the making of such investments appear to serve primarily the interests of the employer rather than those of the employees.

Section 505 of the new code takes a new tack on this subject. With the avowed purpose of protecting employees by insuring diversification, it provides that a trust will lose its exemption for the year unless at the close of each quarter all of its assets are represented by certain specified classes of investments.

In the area where there might once have been some reasonable concern about investments—the area of investments in the securities of the employer, no problem has actually developed. Local trust law and Treasury administration has proved entirely adequate. Section 505 does not affect this area in any event.

No investments are permitted in contracts of ordinary or term life insurance—an area where no protection is necessary. This restriction was apparently imposed on the erroneous theory that such contracts are not an appropriate means of funding pension or profit-sharing obligations, either in whole or in part.

Each real-estate investment, which is sometimes the most attractive class of investment available, is limited to 5 percent in value of the total assets of the trust. For the small trust, this will make such investments substantially unavailable. It will cause needless difficulties for larger trusts, some of which have found it desirable to establish separate subsidiary trusts in each State to

hold title to local real-estate investments. The 10 percent of voting power limitation will cause needless difficulty for trusts which follow the ordinary practice of investing in real estate through real-estate corporations.

The 5 percent of total assets limitation, applied to real estate and corporate securities generally, will be an endless source of difficulty. It will necessitate repeated appraisals. To allow for a margin of error in appraisals of real estate and of the securities of closely held corporations, and to guard against the hazard of fluctuations in the value of assets and of unexpected trust liabilities, assets of these two classes will actually have to be held at a level much below 5 percent.

The penalty on the employer and the employees for a trustee's carelessness or mere lack of foresight in failing to comply with these requirements is out of all proportion to the offense.

The problem of allowable investments for these trusts is adequately met by present law. Section 505 should be discarded.

BUSINESS LEASES BY EMPLOYEE TRUSTS

Section 511 of the new code provides that henceforth employee trusts shall pay a tax on income from certain leases of real estate. even where such trusts are exempt from tax generally, and even where the leases were negotiated prior to 1954.

In considering this decision, it should be remembered that this tax is not limited to unorthodox types of leases. It applies wherever the leased property was purchased subject to a mortgage, and a long-term lease was negotiated. Office buildings and other business properties are common and appropriate trust fund investments, and only long-term leases of such properties are practicable.

It should also be remembered that the practice of exempt trusts of investing in real estate was thoroughly examined by the Congress in 1950, and at that time it was decided that certain classes of these trusts should be taxed on their income from certain of these leases and that others, including exempt employee trusts, should not be. Since 1950 many employee trusts have entered into these transactions relying in good faith on this decision. Employers have entered into long-range commitments to their employees in the case of pension trusts, and employees have made provision for their own future under both pension and profit-sharing trusts. the underlying basis of each of which will be destroyed if this decision is approved in its present form.

If it is believed necessary to subject employee trusts to this tax, even though no similar action is taken against such other classes of exempt organizations as social clubs, fraternal orders, and social welfare organizations, the Congress should at least limit the tax to leases negotiated in the future, so that transactions previously entered into can be carried out as planned on the basis of the decision of the Congress in 1950.

FOREIGN PERSONAL HOLDING COMPANY INCOME

In order to prevent tax avoidance through the use of a foreign corporation as an "incorporated pocketbook," Congress in 1937 provided for taxing the United States shareholders of a foreign personal holding company on the undistributed income of the company in the same manner as if the current earnings had been distributed as a dividend. The same tax treatment is continued in section 551 of H. R. 8300.

In the ordinary case the technique of taxing the United States shareholder on income he has not received from his foreign personal holding company is justified, for the shareholder can avoid any hardship or inequity by causing the corporation (which must be controlled by a limited United States group to qualify as a personal holding company) to pay its current earnings out as dividends. There is, however, no justification for taxing the United States shareholder where both the company and its shareholders want the earnings currently paid out as dividends but the United States Government itself prevents the payment of the dividend.

Such a case is presented where the assets of the foreign personal holding company are located within the United States, with the Government claiming that the assets are subject to liens asserted by the United States with respect to contested taxes. Instances have arisen where a specific request was made to the United States for permission to pay a dividend, notwithstanding the asserted liens, and the Government flatly refused to allow the payment of the dividend.

Under such circumstances, it is extremely doubtful that the shareholder can constitutionally be taxed on the undistributed earnings of the company. In any event, no possible justification exists for attempting to tax the shareholder on earnings the company desires to pay out as dividends, and which the shareholder is willing to receive and pay the individual income tax, but which the Government bars him from receiving.

Section 551 (b) of the bill, and the corresponding provision (sec. 337 (b)) of the Internal Revenue Code of 1939, should be amended so as to relieve the shareholder from tax in any case where, because of tax liens asserted by the United States, request was made to the United States during the taxable year for permission to pay dividends in the amount of the current earnings, but the United States prevented such dividend distribution by failure or refusal to grant such permission.

The amendment to the Internal Revenue Code of 1939 should be applicable to all taxable years beginning after 1939 which are not barred by the statute of limitations.

SOURCE OF INCOME RULES

Part I of subchapter N contains source of income rules, both for purposes of determining income from sources within the United States and for purposes of determining income from sources outside the United States. With the exception of a minor change in the treatment of nonresident alien employees of a foreign branch of a domestic employer, the source rules are unchanged from the 1939 code. By and large this is satisfactory, but the source of income rules on the sale of goods purchased in the United States should be corrected to eliminate the present unrealistic and highly legalistic rule whereby the source of income from the sale of such goods is governed by the country in which title passes. It would be much simpler and more consistent with the proposed policy on the treatment of foreign income earned by domestic taxpayers to provide that personal property exported by taxpayers for use or consumption outside of the United States shall be considered as having been sold outside of the United States.

THE FOREIGN TAX CREDIT FOR PRINCIPAL TAXES

The principal tax concept which is introduced in the bill as an alternative foreign tax credit appears to be a valiant, but not entirely successful, attempt to solve the issue of which foreign taxes should be allowed as a credit when imposed in lieu of income taxes. The new provision would permit a foreign tax credit with respect to one principal tax imposed nationally for each trade or business engaged in by the taxpayer in the foreign country. The principal tax may not be a social security, income, war profits, or excess profits tax. It may not be an excise tax which is generally imposed.

The principal tax provision is deficient in several respects. It provides no relief for a taxpayer who is confronted with both a national income tax and also a special excise tax, such as a severance tax, imposed on his trade or business. It provides no relief for a taxpayer who is subjected to a special excise tax on his trade or business which is imposed at the local or provincial level—for example, the Quebec mining tax. It will undoubtedly create difficult problems in determining whether a particular excise tax is or is not generally imposed. Unlike the credit for taxes imposed in lieu of income taxes under the present law, the amount of the principal tax with respect to which a credit will be allowed is limited to our own income tax rate multiplied by the taxpayer's income from the trade or business upon which the principal tax is imposed.

Elimination of the present "in lieu of" provisions and reliance on the principal tax provisions as a substitute will create unnecessary uncertainty and confusion for taxpayers who have already obtained rulings on the applicability of the present "in lieu of" provision. Furthermore, as pointed out above, some taxes now eligible for credit under the "in lieu of" provision will definitely not qualify under the principal tax provision. The Quebec mining tax, mentioned above, is a case in point. Also, taxes levied in lieu of income taxes, where the tax as a percentage of the income from the business exceeds our own domestic income tax rate, will be denied as a credit to the extent of such excess.

The present provisions with respect to taxes levied in lieu of income taxes should be retained in the law, at least until the language of the principal tax provision has been perfected and its interpretation has been tested in operation for several years, and the principal tax should be made an alternative credit for local and provincial taxes as well as for national taxes.

In fact, no statutory provision can be devised which will settle satisfactorily the problem of which foreign taxes should be allowed as a credit. Tax systems in foreign countries range from the most primitive to the most highly developed, and the types and the number of enterprises taxed vary widely from country to country. It is futile to expect to cover in one statutory provision the complex and diverse tax system of both Great Britain and Mexico, for example. Statutory language cannot be flexible enough to meet the situations which exist or which will arise in the future. The only satisfactory solution to this problem is to negotiate tax treaties which will specify the particular foreign taxes entitled to credit. The Administration should be encouraged to do so.

LIMITATION ON FOREIGN TAX CREDIT

The bill eliminates the existing overall limitation on the foreign tax credit, and retains the per country limitation. The overall limitation is eliminated because it acts as a deterrent, in the case of a company operating profitably in one foreign country, to the commencement of business in another foreign country where the taxpayer may expect to operate initially at a loss.

But precisely the same deterrent can exist under the per country limitation where the taxpayer is receiving dividends from a foreign subsidiary. In such a case the credit for the foreign taxes paid by the foreign subsidiary and on the dividends received from the subsidiary can be lost or reduced if the domestic corporation directly engages in a new venture in the same foreign country (or engages in a new venture through another subsidiary) and sustains losses in doing so. The direct losses sustained will reduce the amount of the foreign tax credit otherwise allowable, without reducing the amount of foreign taxes paid by the subsidiary on its earnings or the amount of the tax paid to the foreign country with respect to the dividends received.

Frequently it is impossible or impracticable to have a new venture in the foreign country undertaken by the subsidiary. For one thing the foreign corporation may not be wholly owned by the American company, and some of the shareholders may be unwilling to embark on the expansion of the company's activities or help finance the new venture. In other cases the foreign subsidiary might be engaged in an entirely different kind of business from that of the new venture.

It is suggested that the deterrent under the per country limitation to the commencement of new business ventures in a foreign country be removed by providing that where a domestic company operates at a loss in a foreign country (determined by ignoring income from dividends, then the tax credit with respect to the dividends received from that country shall be computed by treating all other income and expenses not related to the dividends as not attributable to that foreign country.

INCOME EARNED BY INDIVIDUALS IN FOREIGN COUNTRIES

The Revenue Act of 1951 amended section 116 (a) of the Internal Revenue Code so as to exempt wages and salaries earned in a foreign country from income tax where the taxpayer is present in the foreign country 17 out of 18 months. The Technical Changes Act of 1953 limited the exemption for any year to $20,000. As passed by the House of Representatives, the Technical Changes Act of 1953 would not have effected the complete exemption of wages and salaries received on or before April 14, 1953, since taxpayers were not put on notice as to the possible change in the law until the introduction on April 14, 1953, by the Chairman of the Committee on Ways and Means, of a bill to repeal the exemption. However, as finally enacted, the Technical Changes Act made the $20,000 limitation applicable to all of 1953 without regard to the April 14, 1953, date.

Prior to April 14, 1953, many taxpayers were induced to leave their homes in this country to work abroad, as Congress intended, by reason of the complete exemption from taxation granted by section 116 (a) (2) on salaries earned in a foreign country. Those taxpayers abroad on April 14, 1953, had every reason to believe that the income already earned by them up to that date would be completely exempt from tax, no matter when the income was received, upon meeting the test of presence in the foreign country for 17 months. Certainly as to the income already earned during the period prior to April 14, 1953, it was highly inequitable for Congress to remove retroactively the exemption from tax provided by the 1950 legislation

Section 911 (a) (2) of H. R. 8300, and section 116 (a) (2) of the Internal Revenue Code of 1939, should be amended so as to provide that any income earned prior to April 14, 1953, shall be free from the $20,000 limitation, whether received before or after that date.

WESTERN HEMISPHERE TRADE CORPORATIONS

Two changes have been made in the bill with respect to Western Hemisphere trade corporations. The first change is to insert a specific provision in the law to the effect that incidental purchases outside the Western Hemisphere will not disqualify an otherwise eligible corporation. Since this conforms with the original intent of the Western Hemisphere trade corporation provisions and the understanding as to the meaning of these provisions for many years, the report of the Committee on Finance should make it clear that no contrary interpretation of the provisions in the 1939 code should be implied from the change in language in the new bill.

Also, since the issue has been raised by the change in the language of the provision, the report should make it clear that the purchase of capital equipment does not constitute "doing business," and that the purchase of supplies from sources outside the Western Hemisphere does not constitute doing business unless the taxpayer maintains a permanent establishment outside of the Western Hemisphere to handle the purchasing, warehousing, and transportation of these supplies. No question could be raised on these points in the interpretation of the Western Hemisphere trade corporation provisions unless some adverse implication is drawn from the "incidental purchases" phrase which is being added.

The other change made in the Western Hemisphere trade corporation provisions is the insertion of an automatic formula under which taxpayers subject to both the normal tax and the surtax will be entitled to a deduction which is the equivalent of a 14 percentage point tax credit, regardless of future changes in the rate of either the normal tax or the surtax. While this is consistent with the policy which has been followed with respect to Western Hemisphere trade corporations since the Revenue Act of 1950, it is not consistent with the original intent of the Western Hemisphere trade corporation provisions—i. e., that the corporate surtax was an additional tax, rather than a part of the normal tax system, and should not be imposed on corporations competing in Western Hemisphere countries. The automatic formula contained in the new provisions is merely another step in the process begun by the 1950 act of deliberately obscuring the basic distinction between the corporate normal tax and the corporate surtax.

THE 14-PERCENT FOREIGN INCOME CREDIT

The most important change made by the foreign income provisions of the bill is the allowance, in section 923, of a 14-percentage-point tax credit with respect to certain categories of foreign income earned by domestic corporations. The 14-point credit is allowed with respect to income received as compensation for technical services and income received either directly, or indirectly (as dividends or interest) from foreign subsidiaries, from the active conduct of certain types of trades or businesses. The policy of this provision is in accord with the recommendations of the Randall Commission and will undoubtedly greatly reduce one of the most serious roadblocks to the flow of American capital into foreign investments.

While the broad policy of the 14-point tax credit deserves support, there are a number of deficiencies in the draft of this provision contained in the bill. Perhaps the most obvious criticism is the failure of the bill to allow the 14-point credit to a domestic corporation on its income earned abroad through the direct operation of a branch in the foreign country unless the domestic corporation elects to come within the elaborate deferral provisions contained in part IV of subchapter N.

It is difficult to see why the requirement of election of the deferral provisions of part IV of subchapter N should be imposed as a condition to obtaining the 14-point credit in the case of direct operations abroad. No such requirement is imposed on income received from abroad as compensation for technical services or as dividends or interest from foreign subsidiaries.

The foreign income deferral provisions of part IV are an elaborate and complex machine for the deferral of United States tax on foreign income until the income is brought home. This machine, as presently contained in the bill, has such side effects as the elimination of percentage depletion, taxation of long-

term capital gains as ordinary income, unlimited loss carry forwards, prohibition on use of branch loss to offset other corporate income, unlimited deductions for charitable contributions, and realization of gain or loss on transactions between the corporation's home office and its foreign branch. There is no reason why a domestic corporation which does not wish to become involved in the complexities of this elaborate deferral machine or which does not wish to suffer the proposed adverse consequences of electing deferral should for that reason be denied the 14-point tax credit with respect to income from the active conduct of an otherwise eligible trade or business with a foreign country.

The definition of an active trade or business which is eligible for the 14-percentage point tax credit is deficient on several points. Although factories, mines, oil and gas wells, public utilities, and retail establishments are listed as qualifying, such activities as the farm, plantation and timber operations are not listed, although they are obviously within the scope of the policy of the provision.

Furthermore, by the apparent exclusion of all or virtually all activities of a wholesale or distributive nature from the definition of trade or business, the bill denies the 14-point credit to a number of useful businesses in which corporations have large investments at risk abroad and which require active day-to-day operation and supervision on the same basis as the trades or businesses which are listed as qualifying. These businesses have been excluded, apparently, because of a policy decision to deny the 14-point credit to an entirely different group—exporters who operate from the United States, shipping purchased goods to a foreign country and selling them there and maintaining little or no investment in the foreign country. Actually these exporters should be entitled to the 14-point credit. They are engaged in active business in the foreign country and the mere fact that such business does not require large investment should not bar them from the 14-point credit. However, even if the policy decision to bar the export business is accepted, that is no reason for a sweeping exclusion of all wholesale or job activities.

Secretary Humphrey, in his appearance before the Committee on Finance, testified that wholesalers would be entitled to the 14-point tax credit on income from wholesaling goods produced in the foreign country. He said, "Where the goods originate is the distinction, not the fact that they are wholesalers or retailers at all. The wholesaler gets it (the 14-point credit) the same as a retailer does, doing business in the same place and under the same circumstances." While the provisions of section 923 (and section 951) do not appear to warrant the foregoing statement in their present form, Secretary Humphrey's remarks point up one desirable change in the proposed definition of eligible active trades or businesses. Section 923 and section 951 should be amended so as to specifically include within the term "active conduct of a trade or business" the purchase and sale of goods produced or processed in any foreign country, whether as a wholesaler, jobber, importer, exporter, or retailer.

The basic criterion of the definition of an eligible trade or business should be the maintenance of a permanent establishment in the foreign country which involves a substantial capital investment at risk in the foreign country. Thus, a wholesaler should qualify who has invested substantial sums in warehouses, distribution facilities such as trucks or ships, and inventories located in the foreign country.

An excellent example of a type of business which should be covered is the business of distributing motion-picture films to foreign exhibitors on a rental basis. Domestic corporations (and their foreign subsidiaries) engaged in this business have heavy investments in film printing establishments, sound dubbing and synchronization equipment, film vaults, transportation facilities, show rooms, etc. This is the type of investment which the proposed 14-point credit is designed to encourage, yet there is grave danger that it would not be covered under the bill as now written. The credit should be made specifically applicable to foreign income from motion-picture film rentals, and the active conduct of trade or business for an eligible foreign subsidiary should be defined to include the rental of motion-picture films.

Section 923 (c) limits the aggregate amount with respect to which the 14-point tax credit is allowable from all sources within a single foreign country to the taxpayer's taxable income from that country. In general, this is a desirable limitation. However, it is subject to the same criticism as the per country limitation as it is now written—i. e., that it is a deterrent to new direct investment in a foreign country which may result in losses in the initial years if the taxpayer is already receiving dividends from a foreign subsidiary which qualifies

for the 14-point tax credit under section 923 (a) (3). This can be corrected by making section 923 (c) inapplicable to dividends received from foreign corporations under section 923 (a) (3), similar to my recommendation with respect to the limitation on the foreign tax credit.

It would seem that principles of tax equity and simplicity of administration could best be served by providing, in addition to section 923, simply for an extension of Western Hemisphere trade corporation treatment to the rest of the world, as I have recommended many times in the past.

DEFERRAL OF TAX ON FOREIGN BRANCH INCOME

The policy behind the income tax deferral provisions of part IV of subchapter N is a most desirable one—not merely because it will place certain foreign branches of domestic corporations in a somewhat similar status to that of foreign subsidiaries, but primarily because it will be an incentive to encourage the retention and reinvestment abroad of income earned abroad. This latter aim should be the basic objective of the income tax deferral provisions, rather than a futile attempt to equate the tax treatment of foreign branches and foreign subsidiaries.

There is no objection, of course, to use of the foreign subsidiary analogy, insofar as it is practicable, in drafting the income tax deferral provisions, since these provisions will be complex at best and any analogy which will ease their administration and simplify their understanding is greatly to be desired. However, an income tax deferral system which slavishly follows the example of the tax treatment of foreign subsidiaries to the point of depriving foreign branches of domestic corporations of the benefit of all the tax provisions which are not allowed to foreign subsidiaries will largely defeat the original purpose of enacting a foreign income tax deferral system.

For example, one of the principal reasons why many corporations have elected to set up foreign branches instead of foreign subsidiaries is that they wish to obtain the benefits of percentage depletion. Another major reason is that they wish to be able to use any possible losses incurred in the operation of these branches to offset other income. An elaborate deferral system which fails to take these two factors into account will, of course, be of no interest to these corporations.

Another serious difficulty with the foreign income deferral provisions as contained in the bill is that they apparently would treat any return of investment from the foreign branch to the corporation's home office as being first a withdrawal of earnings, even though the investment may have been in the nature of advances or loans by the home office to the branch. If the foreign income deferral provisions are to have the real incentive effect desired in increasing American investment abroad, a realistic approach would be to treat withdrawals as being first withdrawals of capital invested in the branch.

The committee report states that a Western Hemisphere trade corporation may choose either the income deferral treatment provided by part IV or the Western Hemisphere trade corporation treatment. However, the Western Hemisphere trade corporation provisions are not elective, and a corporation which is allowed the deduction allowed Western Hemisphere trade corporations is ineligible for the deferral treatment provided in part IV. In order to carry out the intent expressed in the committee report, corporations otherwise qualifying as Western Hemisphere trade corporations should be permitted to elect to forego the benefits of the Western Hemisphere corporation trade provisions in cases where they are otherwise eligible under part IV. Exactly this same problem exists with respect to the 14-percentage point tax credit allowed by section 923.

AUTHORIZATION OF TAX TREATIES WITH UNDERDEVELOPED COUNTRIES

Notwithstanding the changes made in the treatment of foreign income under H. R. 8300, serious roadblocks to the flow of American private investment into underdeveloped countries will still exist. In some instances the proposed 14-percentage point tax credit on foreign income will be inadequate. In other instances it will be inapplicable to the types of American private investment needed to meet the needs of a particular underdeveloped foreign country. The principal tax provisions of the bill will be too rigid to conform with the peculiar tax systems of some of the underdeveloped countries.

The only solution to these problems which is sufficiently flexible to meet the peculiar needs of each of the underdeveloped countries in which we are interested is the negotiation of bilateral tax treaties. Such treaties, to do the job, must

be far broader in scope than the traditional double taxation treaties we have negotiated in the past. Since treaties of this type will be a departure from the traditional pattern of tax treaties, Congress should first give them its informal sanction. This should be done by authorizing the negotiation of such treaties by an appropriate provision in H. R. 8300.

EXCHANGE OF INVESTMENT PROPERTY

Section 1031 (a) provides that gain or loss shall not be recognized if property held for productive use in trade or business or for investment is exchanged solely for other property of a like kind to be held for the same purposes, but "stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" are excluded (as under present law) from its application. This means that an investor in securities which have appreciated in value cannot exchange them for other similar securities without being subjected to capital-gain tax. And, since section 1031 (a) is limited to exchanges, the owner of business property will be taxable on gain from the sale of such property, even though it is replaced by other property of a like kind.

The exclusion of virtually all securities from section 1031 (a) and the failure of that section to cover sales and replacements as well as exchanges highlight one of the most unfortunate effects of the capital-gain tax. Persons holding securities which have appreciated in value cannot make a free choice between retaining these securities or replacing them with other similar investments. For example, if an investor holds a share of stock with a basis of $10 and a present value of $110, he cannot afford to dispose of this share of stock and replace it with stock in another corporation which is also selling for $110, even though he believes the other stock is a sounder investment. If he sells or exchanges his present share of stock he may have to pay a capital-gain tax of $25, leaving him with only $85 to reinvest. Consequently, he will not change his investment portfolio unless he believes that an investment of $85 in a new stock is worth more than his present investment of $110 in the old stock. The same problem exists with respect to the replacement of business property unless the taxpayer is fortunate enough to be able to arrange an exchange.

This artificial "notch" area created by the capital gain tax distorts the securities market to the point where it no longer serves as an accurate reflection of current values. And it encourages taxpayers to retain unsafe investments. The problem is particularly serious at the present time due to the inflation in values which has occurred since World War II.

Taxpayers should be permitted to elect to defer the recognition of gain on sale or exchange of securities or other investment property and of property used in the taxpayer's trade or business if such properties are replaced within 12 months by other properties of like kind. Such a provision should at least be made available to trusts and estates, since capital gains are treated as a part of corpus rather than income under trust law, and also to any taxpayer who has held the original investment property for as long as 20 years.

RATE OF CAPITAL GAIN TAX

The United States is one of the few countries which taxes capital gains as income. Economically such a tax is unwise because it distorts the investment market, and revenue-wise the present high rate of tax on capital gains is unwise because it actually reduces the yield instead of increasing it.

If there is to be a tax on capital gains, coldblooded consideration of how to raise the most revenue by it requires recognition of a basic difference between ordinary income and capital gains. By and large, a taxpayer must take his ordinary income currently or lose it forever, regardless of the tax rates. But normally a taxpayer may choose between realizing a capital gain or deferring its realization, possibly until death. When presented with this choice, high tax rates will lead to deferral, with no revenue to the Government. Consequently, maximization of capital-gain tax revenues requires a tax rate low enough not to discourage realization of gains. Furthermore, a high capital-gain tax operates to discourage the making of investments, since taxpayers realize that any potential gain through appreciation in value will be reduced by the tax. Thus capital-gain tax revenues are further reduced by the failure of taxpayers to make investments which may result in gain.

It should be emphasized that a low capital-gain tax rate should remain in force permanently. Once a practical capital-gain tax policy is set, it should be followed

consistently. Frequent fluctuations in the rate are unfair to taxpayers who make investments or who decide to defer realization on gains with the expectation that the tax rate will remain unchanged.

An additional factor in favor of a lower tax rate on capital gains is the inflation in values which has occurred since World War II. To tax the proceeds of a sale in the present inflated market as a gain amounts, in many cases, to what is virtually a capital levy.

It is recommended that the alternative tax on capital gains of corporations and individuals be reduced to 10 percent.

INCLUSION OF FOREIGN TRADE CORPORATIONS IN CONSOLIDATED RETURNS

Under the present law corporations deriving 95 percent or more of their gross income from abroad and 50 percent or more from active conduct of business are not required to be included in consolidated returns unless they have elected to be so included for a taxable year ending after June 30, 1950. This provision covers Western Hemisphere trade corporations and similar domestic corporations doing business in other foreign countries.

This provision has been deleted from section 1502 (b) of the proposed new code, with the result that all such corporations must henceforth be included if consolidated returns are filed. The only reference in the Ways and Means Committee report to this change is the statement in the section-by-section analysis that the definition of includible corporations has been "modified by deleting the provisions which related to the excess profits tax."

While this exception from consolidated returns was of particular importance in connection with the excess-profits tax (since such foreign-trade corporations were exempt from excess-profits tax unless they elected to be included in consolidated returns), its significance is by no means limited to the excess profits tax. This is evidenced by the fact that such an exception was available to foreign trade corporations prior to the enactment of the Excess Profits Tax Act of 1950 if they had not elected, in a taxable year ending after December 31, 1953, to be treated as includible corporations.

Entirely aside from the excess-profits tax, a corporation operating in a foreign country will often simply not fit into the consolidated picture. Furthermore, computation of the foreign-trade corporation's income on a consolidated basis may create difficult situations in dealing with the taxing authorities of the foreign country. These officials are unfamiliar with consolidated accounting, the consolidated books are not available to them, and they may feel that consolidated returns are being used as a device to cheat them. Also, introduction of consolidated accounting concepts into dealings with foreign countries may result in arbitrary foreign-tax provisions denying intercompany deductions and otherwise upsetting long-standing arrangements whereby the foreign country taxes only the corporation operating within its territory. It seems clear from the brief reference in the committee report to this proposed change in the law that the decision to treat foreign trade corporations as includible in affiliated groups in all cases was made without a realization of these important factors.

The definition of includible corporations in section 1502 (b) should include a provision making foreign trade corporations ineligible for inclusion in an affiliated group unless they elect to be so included in a taxable year ending on or after March 31, 1954.

TERMINATION OF ELECTION TO FILE CONSOLIDATED RETURNS

Section 1505 (a) would enact into the law (in considerably more stringent form) the present rule in the cosodilated return regulations that an affiliated group filing a consolidated return for 1 year shall also be bound to file consolidated returns for subsequent years in the absence of certain specified conditions. Under the present consolidated return regulations the principal one of these conditions is that the provisions of the code, or the provisions of the consolidated return regulations, have been amended so as to make less advantageous to affiliated groups as a class the continued filing of consolidated returns.

In practice, changes in the law or the regulations have made it necessary, nearly every year, to allow a new election to corporations filing consolidated returns. However, there is always an element of uncertainty as to whether the Internal Revenue Service will consider a change to be of sufficient importance to warrant the granting of a new election, and there may be prolonged delays before it is announced that a new election is available. Also, a change in the law

or regulations may make consolidated returns disadvantageous as to a particular affiliated group without affecting affiliated groups "as a class," in which event the particular affiliated group affected has to rely on getting special permission to shift to separate returns.

Since a new election is necessary nearly every year because of changes in the law or the regulations it is pointless to continue the delays and uncertainties of the present system of depending on (and waiting on) the Internal Revenue Service's decision as to whether a new election is to be allowed. The requirement that an affiliated group continue to file consolidated returns in subsequent years until excused is completely unjustifiable so long as the 2-percent penalty tax on the filing of consolidated returns remains in effect. It would be simpler, and fairer, to permit an election each year between separate and consolidated returns.

The problem of the binding effect on subsequent years of an election to file consolidated returns is intensified and complicated by the language used in writing this requirement into the new code in section 1505 (a). Whereas the regulations have heretofore allowed a new election in the event of a change which makes "less advantageous" the continued filing of consolidated returns, the provision written into section 1505 (a) allows a new election only in the event of a change which makes the continued filing of consolidated returns "substantially less advantageous." While no one can say with any degree of assurance what "substantially" means in this context, it is certainly more restrictive than the standard the Treasury has imposed in its regulations in the past. Insertion of this word will undoubtedly be interpreted by the Internal Revenue Service as an authorization and probably a command to be more strict than it has been in the past in granting new elections.

A second change made in writing the provisions of the regulations on this point into the law was to drop the authorization for a new election in the event that the consolidated return regulations themselves are changed so as to make consolidated returns less advantageous. Possibly this provision was left out on the theory that the enactment of detailed consolidated return rules in the law rendered it unnecessary. And certainly the enactment of detailed consolidated return provisions should reduce the frequency with which changes in the regulations will occur which make continued filing less advantageous. However, there will be regulations under the new consolidated return provisions, and there will be occasions on which these regulations will be changed so as to make continued filing of consolidated returns less advantageous (or even "substantially" less advantageous). When these occasions arise there is no reason why a new election should not be allowed—as it is today.

Perhaps the best illustration of the confusion and illogical consequences of the failure to allow a simple annual election between separate returns and consolidated returns is the treatment in section 1505 (a) (2) of the problem of which year the new election applies to in the event there is an amendment of the law which makes the continued filing of consolidated returns substantially less advantageous to affiliated groups as a class. Section 1505 (a) (2) grants the new election for the first year for which a tax return is filed after the date of enactment of the amendment, regardless of the effective date of the amendment. In other words, if H. R. 8300 is enacted into law in July 1954, a new election by reason of its enactment would be allowed for the fiscal year ending June 30, 1954—and not for the fiscal year ending June 30, 1955—merely because the return for the year ending June 30, 1954, is filed after the date of enactment of the bill, although the consolidated return provisions of the bill will not affect the year ending in 1954 and will have a drastic effect on the year ending in 1955.

It is difficult to see any logical justification for requiring an affiliated group to choose whether to continue filing consolidated returns this year on the basis of changes in the law which will affect the group only if it files a consolidated return next year. This requirement has the same effect, in some cases, as though the consolidated return provisions of the bill were made effective retroactively for the past year—which is something Congress would obviously never think of doing. Taxpayers with fiscal years ending after the date of enactment of H. R. 8300 (and those with fiscal years ending before its enactment, if they file their returns after its enactment) will be forced to elect separate returns for such years—although they have conducted their affairs during the year on the assumption that they would continue to file consolidated returns—merely because of the effects the bill will have on the filing of consolidated returns for the succeeding year.

Unless an annual election to shift from consolidated to separate returns is permitted, section 1505 (a) (2) should be amended to strike out the word "substantially," to permit new elections when the consolidated return regulations are changed, and to make the new election applicable to the first taxable year affected by a change in the code or the regulations.

THE 2-PERCENT PENALTY TAX ON CONSOLIDATED RETURNS AND THE TAX ON INTERCORPORATE DIVIDENDS

In his tax message to Congress in January, President Eisenhower recommended the elimination of both the 2-percent penalty tax on consolidated returns and the tax on intercorporate dividends. Although these were among the most important reforms suggested by the President, neither was adopted by the Committee on Ways and Means. No thoroughgoing reform of our tax laws could permit retention of either of these taxes.

An affiliated group of corporations filing a consolidated return is required to pay a penalty for this privilege in the form of an extra tax of 2 percent on the surtax net income of the group. This is a penalty on the choice of a method of reporting which is more accurate and realistic than the use of separate returns. By filing a consolidated return the affiliated group loses the benefit of all but one of its $25,000 surtax exemptions, and this is proper because the group is electing to be treated as a single entity. But there is no similar justification for the additional 2-percent tax.

It has sometimes been argued that the 2 percent penalty tax is designed to compensate for the tax which would otherwise be collected through inclusion in taxable income of 15 percent of intercorporate dividends paid between the members of the affiliated group. However, the tax on intercorporate dividends is, itself, an unjustified double tax, and it should certainly not be used as an excuse for the equally unjustified 2 percent penalty tax on consolidated returns. Furthermore, any relationship between the 2 percent tax on surtax net income and the 52 percent tax on 15 percent of intercorporate dividends is merely fortuitous. Losses by some members of the group may completely offset the income of the other members, so that there is no consolidated corporation surtax net income and consequently, no 2 percent tax, even though there are intercorporate dividends which would have been taxable if separate returns had been filed. On the other hand, the 2 percent penalty tax may apply even though no intercorporate dividends are paid during the year. The only fair method of equating the treatment of intercorporate dividends as between consolidated returns and separate returns is to abolish both the 2 percent penalty tax and the double tax on intercorporate dividends. The latter can be accomplished by allowing deduction of 100 percent of ordinary intercorporate dividends received (without limitation) and deduction of 73 percent of intercorporate dividends received on certain preferred stock of public utilities with respect to which a deduction is allowed the payer under the proposed section 247.

DOUBLE TAXATION OF INVENTORY PROFITS IN CONSOLIDATED RETURNS

Section 1708 (b) writes into the proposed 1954 code a provision from the present consolidated return regulations which provides a double tax on intercompany inventory profits as a condition to the election to go on a consolidated return basis. The situation is exactly comparable to the double tax previously required as a condition to shifting from the accrual basis to the installment basis of accounting—which is eliminated under this bill.

Under this provision corporations electing to file consolidated returns are required to reduce their opening inventories for the first consolidated return year by the amount of profits previously realized by other corporations in the affiliated group on items included in such inventories. The effect of this inventory reduction is to increase net income by that amount in the first consolidated return year. Of course the profits have already been taxed in the preceding separate return year to other members of the affiliated group.

This is admittedly, and deliberately, a double tax on profits realized on inventory items among members of the affiliated group. It has been justified by arguing that, without the second tax on these profits, income for the affiliated group would be lower than normal in the first year for which consolidated returns are filed, since the closing inventory of a corporation in the group for such year will be valued at its actual cost to the group rather than reflecting profits realized by other members of the group as would be the case if separate returns were

filed. Consequently, in order to prevent this temporary reduction in income, income is increased by profits realized by other members of the group in the previous year on items included in the corporation's opening inventory.

It should be emphasized that the drop in income in the first consolidated return year which is used to justify the double tax is a purely temporary phenomenon. It has no effect on income in subsequent consolidated return years, and it will be automatically compensated for by a corresponding increase in income in the first year after the group ceases to file consolidated returns.

Section 1708(c) (also repeated from the regulations) alleviates the double tax to some degree in the first year after the corporation ceases to file consolidated returns by providing that the opening inventory for that year shall be increased by the amount of intercompany profit with respect to items contained therein which was eliminated in the last consolidated return year. Of course, due to changes in volume of business or method of doing business this latter adjustment may only partially offset the double tax previously collected. In any event it is not allowed to exceed the previous downward adjustment of inventories. And it is further limited to the amount of intercompany profits actually reflected in closing inventory for the first separate return year. Thus if, for example, the stock of the corporation in question is sold by the group and it does no business with the other members of its former affiliated group in its first separate return year, there would be no inventory adjustment to compensate for the previous double tax.

It is suggested that section 1708 (b) be eliminated from the bill. Section 1798 (c) should be retained simply to provide relief for corporations breaking consolidation which were subjected to the double tax on intercompany inventory profits under the consolidated return regulations for past years, but it should be modified to provide an increase in the opening inventory for the first separate return year which is exactly equal to the decrease made in opening inventory for the first consolidated return year.

CONTEMPLATION OF DEATH

By section 501(a) of the Revenue Act of 1950, Congress provided that inter vivos gifts made by a decedent more than 3 years prior to his death shall not be deemed to have been made in contemplation of death for purposes of the estate tax. That amendment was prompted by the fact that the vague nature of the contemplation of death concept made it possible for Treasury agents to assert that virtually all substantial gifts, regardless of when made, were in contemplation of death. As a result many cases were settled with the Treasury even though the gifts were not made in contemplation of death, merely because executors were unwilling to enter into expensive and protracted litigation.

The amendment made by the 1950 act applied only prospectively—to decedents dying after September 23, 1950, the date of enactment of the 1950 act. Consequently, estates which are still open of decedents who died before that time are still faced with the same problem of coping with unwarranted assertions of the contemplation of death provision, even though the gifts may have been made 10 or 12 years before death, for adequate reasons not connected with death, and by donors in good health with every expectation of a long life. Although these decedents died before the enactment of the Revenue Act of 1950, this is a current problem for their estates, and they should have the benefit of the 3-year rule.

The 3-year rule with respect to contemplation of death should be made applicable to decedents dying on or before the date of the enactment of the Revenue Act of 1950, but cases barred by the statute of limitations or otherwise should not be reopened.

EMPLOYEE ANNUITIES UNDER THE ESTATE TAX

Under section 2039(c) of the bill the policy is adopted of excluding from the decedent's gross estate the value of an annuity or other payment receivable by a beneficiary, other than an executor, under a qualified pension or profit-sharing plan.

These are two defects in this provision. One is that the exclusion does not extend to an annuity contract purchased by an employee's trust, as distinguished from direct distributions from such a trust, and from an annuity purchased by the employer himself. The other defect is that the exclusion extends only to annuities and other payments receivable under plans qualified under the new mathematical rules of section 501 (e), as distinguished from those qualified under section 165 (a) of the present code.

There is no conceivable reason for denying the exclusion in either situation. The omissions are probably inadvertent, and in any event should be corrected.

REVERSIONARY INTERESTS IN CASE OF LIFE INSURANCE

On three recent occasions Congress has granted relief with respect to the treatment, for estate-tax purposes, of reversionary interests in life insurance policies transferred by a decedent during his lifetime. Section 503 of the Revenue Act of 1950 provided that an insured's reversionary interest would not be treated as an incident of ownership unless at some time after January 10, 1941, the value of the reversionary interest exceeded 5 percent of the value of the policy and the reversionary interest arose by the express terms of the policy or other instrument and not by operation of law. The 1950 amendment granted relief only to estates of decedents dying after October 21, 1942. By section 610 of the Revenue Act of 1951, Congress removed the bar of the statute of limitations, in certain cases, to refunds resulting from the 1950 amendment.

In the Technical Changes Act of 1953, Congress extended the relief provided by the 1950 legislation to the estates of decedents dying after January 10, 1941. But none of the legislation to date has granted relief to decedents who died on or before January 10, 1941. As a result, in the case of a decedent dying on or before January 10, 1941, a reversionary interest owned by the insured at the date of his death, even though worth only a small fraction of 1 percent of the value of the policy, is still treated as an incident of ownership in the policy. There is no reason why a minute reversionary interest in the insured should be treated as an incident of ownership if the decedent died prior to January 10, 1941, but not if he died after that date.

Congress should now provide that in the case of a decedent dying after February 10, 1939, and on or before January 10, 1941, a reversionary interest in life insurance taken out by the decedent on his own life will not be treated as an incident of ownership, for the purpose of determining the includibility of the insurance in his gross estate under section 811 (g) of the Internal Revenue Code, unless the reversionary interest at the time of his death exceeded 5 percent of the value of the policy and the interest arose by the express terms of the policy or other instrument and not by operation of law.

Congress should also provide that refund of any overpayment resulting from the amendment should be allowed (but without interest) if claim therefor is made within 1 year after the date of the enactment of the bill, even though refund of the overpayment would otherwise be barred by the statute of limitations or any other law or rule of law. In any case where an estate tax was paid on insurance because the Bureau insisted the insurance was includible in the gross estate by reason of an asserted reversionary interest in the insured, the rule announced by the Court of Claims in *Guggenheim* v. *United States* (1953) 116 Fed. Supp. 880 will apply if the Bureau should reverse its position and claim that no reversionary interest was in fact owned by the decedent at the time of his death.

EXCISE TAX ON FARM-EQUIPMENT PARTS

Both the present code and the proposed new code levy an excise tax of 8 percent (5 percent after April 1, 1955) on the sale by the manufacturer of parts or accessories for trucks, automobiles, and other highway vehicles. The Treasury Department recognizes that parts sold for use in the manufacture of farm equipment are not subject to this tax, even though such parts may be physically suitable for use on trucks or automobiles. For some years, however, it has taken the position that the tax applied to other sales of parts physically suitable for automotive use—even sales for use as farm-equipment repair parts.

In the Revenue Act of 1951, the Congress sought to complete the exemption of farm-equipment parts from this tax. Its action took the form of an amendment to section 3443 (a) of the present code (corresponding to section 6416 (b) of the new code) authorizing a credit or refund of the tax in the case of parts "used or resold for use as repair or replacement parts or accessories for farm equipment."

Unfortunately, since the enactment of the 1951 act, the allowance of a credit or refund has been prevented in the great majority of the cases to which the 1951 amendment applies. The reason for this is the manner in which the taxpayer's right to a credit or refund must be established. The Treasury Department has taken the position that tax must still be paid upon the initial sale of farm-equipment parts by the parts manufacturer (unless sold to be used in the manufacture of farm equipment), and that it will be refunded only upon a certificate from a party to the retail sale of the parts referring specifically to each

sale and stating that the parts sold were to be used for the repair of farm equipment.

Ordinarily it is not practicable to claim a refund in this manner. There are many thousands of retail dealers in farm equipment. Each year the average dealer makes many thousands of separate sales of repair parts—both of parts which were initially taxable (because physically suitable for automotive use) and of those which were not. The different types of farm-equipment repair parts (taxable and nontaxable) used on each brand of farm equipment number in the tens of thousands. Obviously it would be a very considerable burden on a dealer to be required, on every occasion on which he makes a sale of a farm-equipment part, first to ascertain whether that piece was initially taxable or nontaxable, and, if taxable, to make a written record of the sale, and finally to assemble such records of a number of sales and transmit them periodically through trade channels back to the parts manufacturer. Furthermore, where the retail dealer handles farm equipment only, and all or substantially all of his sales are for farm-equipment purposes, as is frequently the case, the burden of complying with this refund procedure would be especially heavy and especially unnecessary.

It is believed that the manufacturer's price on the average taxable farm-equipment part is substantially less than $1. The tax is therefore less than 8 cents. The tax saving made possible by this burdensome refund procedure is obviously inadequate to compensate for the cost of the clerical labor which would be incurred in order to secure the saving—not to speak of the administrative costs which would be imposed on the Internal Revenue Service if these refunds were claimed and if the Service actually undertook to examine and audit the immense volume of certificates which would then be filed pursuant to its procedures. As a matter of fact, very few dealers have made the required records, very few refunds have been paid under the 1951 amendment, and farmers buying farm-equipment parts continue to pay this tax which the Congress actually levied on truck and automobile parts.

This situation can be corrected by providing an outright exemption for farm-equipment repair parts. The exemption should be closely circumscribed so as to prevent the escape from tax of sales of parts to be used on trucks or automobiles, but should be allowable on terms which could be established at less than the prohibitive cost of the present refund procedure. The present refund procedure should be retained for possible use in cases which could not meet the requirements of the new exemption provision.

The proposed exemption should be allowable only under the following conditions: (a) That the initial sale be from or to a manufacturer of farm equipment; and (b) that the parts be manufactured or purchased for sale or resale as repair parts for farm equipment manufactured by such manufacturer. Thus, right to the exemption should be established at the farm-equipment manufacturers' level with respect to sales in quantity lots, without the necessity of certificates with respect to each sale made to or from a retail dealer.

It is believed that such conditions would adequately insure that the exemption would seldom be allowed with respect to parts eventually used for other than farm-equipment purposes. But as a further guaranty against the opening of a loophole in the tax, the tax should be imposed on sales by dealers of equipment which have not been taxed at the manufacturer's level but which is purchased for use on nonfarm equipment.

This proposal for farm-equipment repair parts is similar to that which was adopted for gasoline substitutes in section 506 of the Excise Tax Reduction Act of 1954.

SILVER BULLION TRANSFER TAX

Under section 1805 of the 1939 code (sections 4891–4897 of the proposed 1954 code), profits on transactions in silver bullion are subjected to a special 50 percent excise tax. This tax was enacted as a part of the Silver Purchase Act of 1934. It does not apply to newly-mined domestic silver purchased by the Government and, since most domestic silver is so purchased, the tax applies almost exclusively to transfers of foreign silver.

In theory, the purpose of the tax was to tax profits which might result from a continuing policy by the Government of making heavy purchases of foreign silver. In fact, the Treasury has never purchased foreign silver in the quantities contemplated by the Silver Purchase Act of 1934; and the Treasury has purchased no silver at all under the act since May 1942—nearly 12 years ago.

Meanwhile the tax has continued in effect, preventing a normal and useful commodity market in silver in this country. As a result, the opportunity is reduced for enterprises in the United States to earn income from smelting, refining, manufacturing, marketing, insuring, and trucking silver mined in other countries, and American businesses which process silver have no market on which they can hedge their commercial silver inventories. Furthermore, the Treasury has lost revenue by losing tax on income Americans formerly earned from commissions on sales and from refining operations on silver from other countries.

For the past 3 fiscal years receipts from the tax on silver bullion has been as follows:

1951	$100,335
1952	86,374
1953	97,000

It is clear that there has been no justification for this tax since the Treasury ceased purchasing foreign silver in 1942. It probably had no justification even prior to 1942.

The tax is a needless hindrance on normal commercial operations. It discriminates against the creation of an ordinary market in one commodity. And it undoubtedly brings in less revenue than the cost of its administration. The silver bullion transfer tax should be eliminated from this bill.

ADVANCE TAX PAYMENTS BY CORPORATIONS

Section 6016 of the bill introduces the new idea of advance, estimated tax payments by corporation. When the new system is fully effective corporations with income tax liabilities in excess of $50,000 will be required to make payments equal to 25 percent of such excess by the 15th day of the 9th month of the taxable year and by the 15th day of the 12th month of the taxable year. The remaining payments will be made in 2 equal installments on the 15th day of the 3d month and on the 15th day of the 6th month following the close of the taxable year. The new system is to be introduced by stages over a 5-year period, with the first advance payments for calendar year corporations in the last half of 1955.

This provision comes on the heels of the acceleration of corporate tax payments from 4 quarterly payments to 2 quarterly payments. This latter change, initiated by the Revenue Act of 1950, will become fully effective for calendar year corporations only with respect to payments made in 1955. Thus, a corporation will be required to pay all its 1954 tax in the first 2 quarters of 1955 (instead of 90 percent, as is the case with respect to payments in 1954) and will also be required to pay 10 percent of its 1955 tax in the last 2 quarters of 1955. The whole course of the acceleration of corporate tax payments under the 1950 act and the plan for advance payments under this bill is illustrated for calendar year corporations by the following table. For purposes of simplification, tax liability is assumed to be constant throughout.

Year of payment	Quarters				Total payments
	1st	2d	3d	4th	
1950	25	25	25	25	100
1951	30	30	20	20	100
1952	35	35	15	15	100
1953	40	40	10	10	100
1954	45	45	5	5	100
1955	50	50	5	5	110
1956	45	45	10	10	110
1957	40	40	15	15	110
1958	35	35	20	20	110
1959	30	30	25	25	110
Total payments in 10 years					1,050

As the above table makes clear, in each of the next 5 years a corporation to which section 6016 is applicable will be required to pay 110 percent of its tax liability. By the end of the five-year period it will have paid the Treasury an additional one-half year's tax. This is a very substantial concealed income tax increase, which has been treated in the committee report as merely a readjustment in tax payment schedules for the convenience of the Treasury. It is a par-

ticularly burdensome hardship coming, as it does, before taxpayers have been fully adjusted to the acceleration from 4 to 2 quarterly payments of the previous year's tax.

The advance payment system has been justified on the grounds that it is necessary to prevent undue bunching of revenues in the first 6 months of the year. If this is an important consideration to the Treasury the cure is to go back to the system of four equal quarterly payments which was in effect before the Revenue Act of 1950.

PERIOD OF LIMITATIONS ON CRIMINAL PROSECUTIONS

Among other changes, section 6531 provides for the running of the period of limitations on criminal prosecutions unless the person is outside the United States or is a fugitive from justice. Under present law some courts have reached the conclusion that the period of limitations on criminal prosecutions is tolled while the person is outside the Federal judicial district in which the crime was committed—regardless of whether he is a fugitive. This interpretation, coupled with the fact that the crime of filing a false return is committed where the return is required to be filed and the fact that many persons are required to file their tax returns in judicial districts other than those in which they live, means that the statute of limitations on criminal prosecution for offenses under the tax laws may never run for many people.

Section 6531 would correct this situation, but unfortunately, as the bill is now written, the correction would apply only with respect to returns filed for future years. Under section 7851 (a) (6) and (d) all the old rules with respect to periods of limitations would remain in effect as to returns filed under the 1939 code or prior Revenue Acts. Thus, for example, the period of limitations on criminal prosecution may never run on tax returns which have already been filed by residents of the District of Columbia with the Collector (or Director) of Internal Revenue at Baltimore, Md. To correct this situation the second sentence of section 6531 should be made applicable with respect to all prosecutions commenced after the effective date of H. R. 8300.

WAIVERS AS EFFECTING TRANSFEREE REFUNDS

Under present law the execution by a taxpayer and the Commissioner of a waiver extending the time within which a deficiency may be assessed against the taxpayer also operates to extend the time (for the same period plus 6 months) within which the taxpayer may claim a refund. But the Treasury takes the position that the law on waivers by transferees does not have the same mutuality of operation. Although the law clearly authorizes waivers of the statute of limitations on assessments against transferees, the Treasury maintains that these waivers do not automatically extend the limitation period on transferee claims for refund, and that the law does not authorize any such extension. See sections 276 (b), 311 (b), and 322 (b) of the present code.

The inequity of this situation may be illustrated by the following example. On December 31, 1948, corporation X, a wholly owned subsidiary of corporation Y, was liquidated. All of the assets of X, subject to its liabilities, were transferred to Y, and Y continued the operation of the business of X as a division of Y. In January 1952 and again in January 1953 the revenue agent, not having had an opportunity to audit X's 1947 and 1948 returns, asked Y to join with the Commissioner in the execution of a transferee waiver for those 2 years, and Y did so. In July 1953 the agent, then having completed his audit, reported a deficiency of $10,000 for 1947 and an overpayment of $10,000 for 1948. Even though Y and the Government are in agreement as to the correctness of the agent's determinations, Y is required to pay the deficiency but, according to the Department's position, is not entitled to the refund.

It seems unlikely that the Congress could have intentionally failed to provide that transferee waivers should extend the period for claims for refund in the same manner as ordinary taxpayer waivers. It could hardly have done so by reason of the prohibition on the assignment of claims against the United States. See 31 United States Code, section 203. The courts have recognized many exceptions to this prohibition (e. g., corporate mergers and liquidations), and the fact that many transferees have no right to prosecute such claims is obviously not a justification for barring the claims of other transferees so long as they are subject to the assessment of deficiencies.

Section 6901 (d) of the new code as passed by the House would correct this situation, but only with respect to overpayments of tax effected by the transferee itself. This qualification should be removed so that a transferee waiver will

extend the time within which the transferor's liability may be reexamined for all purposes affecting the secondary rights as well as the secondary liabilities of the transferee.

This amendment should apply to all years which are still open for assessment purposes on the date of enactment. A similar policy was followed with respect to the provision making taxpayers' waivers effective to preserve the right to refunds. See section 169, Revenue Act of 1942, and section 509, Revenue Act of 1943.

VENUE IN CRIMINAL PROSECUTIONS

Section 7494 provides new rules on venue in criminal prosecutions arising under the tax laws. The basic change made by this provision is a good one; i. e., to change venue in certain cases from the Federal judicial district in which the return is required to be filed to the Federal judicial district in which the defendant resides. This would mean, for example, that venue in a criminal prosecution of a resident of Washington, D. C. would lie in the District of Columbia instead of in Baltimore, Md., where District of Columbia residents are required to file their tax returns.

However, section 7494 raises a number of technical problems. For example, the provision contains no rule as to venue in the case of a nonresident alien who files a false return by mail. Also, it is not clear how section 7494 operates in the case of a defendant charged with assisting in the preparation of a fraudulent return. And apparently venue would not lie in the judicial district of the defendant's residence in the case of a false oral statement or delivery of a false document by hand, even though such acts took place in the judicial district where the defendant resides. Furthermore, it is not clear whether or not section 7494 is intended to supersede section 3237 of title 18, United States Code.

The provision in section 7494 (1) (B) that a return shall be deemed to have been filed "at the office of the principal internal revenue officer for the internal revenue district" unless sent by mail raises the question of which revenue district. Presumably the reference is to the revenue district in which the return should properly be filed. If so, the committee report should so state.

AVERAGING THE EXCESS PROFITS TAX

Determination of excess profits tax on a year-by-year basis has caused serious inequities for taxpayers earning more than their excess profits credits in some years and less in others. Some corporations have paid excess profits tax even though their total income for the period the tax was in effect was less than their total excess profits credits. A taxpayer's excess profits have not been measured fairly if it is required to pay excess profits tax for some years while it has an unused normal earnings credit for others.

The only fair method of measuring excess profits is to total a taxpayer's income over the entire life of the tax and compare this amount with the total of the taxpayer's normal earnings credits during the life of the tax. It was not practical to do this while the excess profits tax was still in effect. Now, however, the tax has expired after 3½ years. The short period the tax was in effect is a reasonable and practical averaging period, and in fairness to taxpayers with fluctuating incomes their income subject to excess profits tax should be limited to the excess of their average excess profits net income over their average normal earnings credit.

As a policy matter, the complete fairness of the averaging proposal is readily apparent. As to the technical aspects of drafting the proposal, the tax should not be less than the tax which would be imposed by permitting an unused excess profits credit to be carried backward or forward to all other years subject to the tax.

The CHAIRMAN. Mr. White, please.

Sit down and be comfortable, Mr. White.

STATEMENT OF JOHN C. WHITE, COUNSEL, ANDERSON, CLAYTON & CO., HOUSTON, TEX.

Mr. WHITE. My name is John C. White. I am counsel for Anderson, Clayton & Co., of Houston, Tex. I have filed with the committee, Mr. Chairman, a statement with respect to the effect of Section

923—Business Income from Foreign Sources, which I ask be made a part of the record.

The CHAIRMAN. It will be incorporated in the record.

Mr. WHITE. Anderson, Clayton & Co. is known primarily in this country, I think, as a cotton merchant. Actually, its operations in cottonseed and the products of cottonseed are at times more important to it than in the cotton lints.

I brought along, just in case the committee didn't know just what happened to cotton, the form in which it was bulked. First, some cotton with the seeds still in it. This is as actually picked; the seed when it has been ginned, in the indentifiable form of a seed; and the lints, after coming through the gin is in this much more beautiful shape. This is what I think they call in California "white gold."

I mention this because it is important to understand that in each of these foreign countries into which Anderson, Clayton has gone, the first step has been that of merchandising the cotton.

Then, in order to make that merchandising official, it became necessary to build cotton gins. And if you have before you the statement which I have given to the committee, the last sheet is a consolidated position statement of credit and capital employed by Anderson, Clayton & Co.

The CHAIRMAN. Is that in your statement? Has the statement been presented to you, Mr. Reporter?

Mr. WHITE. Yes. It shows in foreign countries, for instance, Anderson, Clayton has a total of $43 million invested in physical facilities. Those are primarily Brazil, Mexico, Peru, Argentina, Egypt, and Paraguay.

It shows in addition—and this is the point of my story—that they have employed in those same foreign countries $70 million in current position, in addition to their physical assets.

The amendment which we have suggested is applicable to 923 (b) (1) (A) which is at the top of page 223 of the bill. It is to insert, after the word "retail," "or in carrying and merchandising products of the country without the United States."

The CHAIRMAN. We have had many complaints on that. Personally, I can't see—this is tentative in my own viewpoint, without counseling with the other members of the committee—I can't see any sense to some of these limitations.

Mr. WHITE. Actually, from my own study I have not been sure that the langauge intended to eliminate operations of the type conducted by Anderson, Clayton. Certainly it has very large developments. Certainly all of its business as an integrated whole is carried on through these establishments which are definitely located in the foreign countries.

The CHAIRMAN. What I am trying to say is you don't need to belabor the point because it has been brought here many times and the staff is giving it very careful consideration.

Senator LONG. Have you found it necessary to build cotton gins in foreign nations in order to gin the cotton that is produced in this Nation?

Mr. WHITE. No, sir, it is to gin the cotton located there. Just as in this country we found it necessary to build gins—particularly in the western areas as cotton has developed there.

Senator LONG. I simply didn't understand what you had in mind. You are not saying you had to build gins in other countries for the cotton produced here. You gin it where you produced it?

Mr. WHITE. That is right.

Then you would suggest, Mr. Chairman, that my case is very pretty fully before you?

The CHAIRMAN. As far as that point is concerned it has been very well covered before the committee and I know the staff will give it very careful consideration. And I am personally in considerable sympathy with this question of the limitation of different types of business abroad.

Mr. WHITE. That is what we feel, where a local operation is really a local operation. It doesn't involve a treaty question or any exports or subsidies, which the Secretary of the Treasury is concerned with.

The CHAIRMAN. Which are the principal cotton-producing countries outside of the United States?

Mr. WHITE. Brazil, and in this area, Mexico. Argentina produces a little. Peru has a rather peculiar long staple cotton. And Egypt, of course, has a very long staple cotton. India produces a short staple cotton, but we have never succeeded in doing business with India.

The CHAIRMAN. Which countries are expanding the production of cotton?

Mr. WHITE. The expansion has been in Mexico. Brazil is relatively static.

The CHAIRMAN. Aren't they building up irrigation projects along the Nile to expand cotton producing acres?

Mr. WHITE. I think there has been some expansion there, but not competitive with ours to any great extent.

The CHAIRMAN. And is the same true in India?

Mr. WHITE. Yes, it is true. There again you have the big food question, that they can't divert much land from food to cotton.

The CHAIRMAN. Thank you very much.

Mr. WHITE. Thank you.

(The prepared material of Mr. White follows:)

STATEMENT OF JOHN C. WHITE, COUNSEL FOR ANDERSON, CLAYTON & CO., HOUSTON, TEX., REGARDING SECTION 923, BUSINESS INCOME FROM FOREIGN SOURCES

Anderson, Clayton & Co. is engaged in cotton merchandising and in oil milling, ginning, manufacture of vegetable oil products and activities auxiliary to them in the United States. It is best known for its operations as a cotton merchant, though from the point of view of gross and net income the industrial activities may be more important in a particular year.

Anderson, Clayton & Co. has developed similar integrated operations in other cotton-producing countries, notably Brazil, Mexico, Argentina, Peru, Paraguay, and Egypt. While in each country the first operation has been cotton merchandising, that and the related activities have developed coordinately. Tremendous spreads between the prices growers received for their lint cotton and the prices at which it was sold to textile mills were dictated by poor merchandising methods and lack of modern handling facilities. Cottonseed were not only worthless, they presented a disposal problem. Construction of efficient cotton gins, and cotton warehouses and compresses, was a first necessity. Efficient merchandising operations from the purchase of the farmers' crop to its delivery to the textile mills require large working capital. Cottonseed crushing mills, refineries, and shortening, salad oil and margarine plants, are necessary to utilize the cottonseed, which in some cases was simply dumped in the rivers. Construction of fertilizer and insecticide plants became necessary to provide these essentials to cotton production and further working capital

investment was required for crop financing. The table attached shows the credit and capital employed as of January 1, 1954, both here and abroad.

In each of the countries mentioned the development is done through a local corporation, or corporations, but run by American know-how and financed by capital furnished from the United States and its own earnings. The need for such capital and the opportunity for its employment continues to expand. There are risks in foreign investment additional to those encountered in this country; and, when Anderson, Clayton & Co. stock was first placed on the public market, its highly experienced investment bankers advised that investors would discount its foreign investments and earnings. Because of this and because the continued and increasing foreign investment is needed to develop a high level of international trade, we believe the 14 percent reduction provided on foreign income is justified.

The economic activity being carried on by the foreign subsidiary in each of the countries mentioned is highly significant. The total investment in plant amounts to more than $38 million and in current assets to more than $70 million. In every case the product being handled is a local crop of major importance and, through its sale in foreign markets, a major source of foreign exchange. The vegetable oil products have been an important contribution to the local diet and standard of living. The operations certainly meet the standards set out on page 75 and A 255 of the House report. None of them raise the question of the possible treaty conflicts mentioned by the Secretary of the Treasury, since the products handled are locally produced and not exports from the United States, and only a few bales are sold in the United States.

Nevertheless, it is impossible to say positively from the language of the bill itself that the 14 point credit will be available on earnings from these operations.

Section 923 (b) (1) (A) excludes from the term trade or business "the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise."

Anderson, Clayton & Cia., Ltda., buys seed cotton in Brazil, and after ginning, bailing, classing, storing and assorting the lint cotton, sells it to textile mills in Brazil, and other foreign countries. These operations in between the purchase and sale are surely such that the seed cotton is "processed, manufactured, or changed in form" so that if the House committee report (p. A 255) is controlling, "this exclusion does not apply." But the language of the bill itself is not so clear, and certainly the Brazilian corporation is heavily engaged in the purchase of seed cotton and the sale of baled cotton lint, both of which are goods and merchandise. This particular subsection 923 (b) (1) (A), therefore, seems to require modification, and we respectfully urge that it should be made clear that a merchandising operation in local product, requiring working capital and the carrying of inventories, comes within the activities for which the rate reduction is permitted.

There are particular risks with respect to investment and use of working capital and current assets in foreign cotton producing countries. Physical assets, such as plant and equipment, remain relatively stable in dollar value, unaffected by wide currency fluctuations. Current assets, however, which are the basic essential of a merchandising business in local products, are constantly affected by currency devaluation and fluctuation. On Saturday, for instance, when Mexico unexpectedly devalued her peso from 8.65 to 12½ to a dollar, the dollar value of the current assets in Mexico was immediately and adversely affected. Cash, accounts receivable, crop loans and inventories were immediately, though not necessarily proportionately, reduced in dollar value. Yet anyone engaged in carrying and merchandising these crops must have substantial investments in these very items. As the attached table shows, subsidiaries of Anderson, Clayton & Co., on January 31, 1954, had $20,128,000 in this current position in Mexico; they had $37,578,000 in Brazil and a total of $70,308,000 in foreign countries, almost double their net investment in property, plant, and equipment and noncurrent assets which aggregated $35,448,000.

Presumably, it would be possible to separate specific cotton merchandising activities, but our whole policy both here and abroad has been the opposite. There are wide and shifting variations in the profitability of particular operations. Last year, for instance, cotton handling in Brazil showed a half million dollar loss while the oil mills and gins earned $116,237.45 and the finished products division a little over a million. For Anderson, Clayton & Co., S. A. de C. V. in Mexico cotton trading showed a profit of $304,269.89 while the oil mills and gins and finished products showed losses. In other years these situations will be reversed. It is one thing to separate the costs and profits arbi-

trarily for internal control purposes, but it would be more difficult and questionable to do so for tax purposes. In Brazil there is the added difficulty that every intercompany trade would be subject to a 3 percent transaction tax. If a cotton merchandising corporation were created it would thus have to pay an additional tax of 3 percent on the value of the seed sold to the oil mill company, a cost which is not now incurred.

Efficient merchandising of important local crops is of the utmost importance to the development of foreign agricultural countries. It is more difficult to obtain essential working capital locally for such merchandising, both because such capital tends to go into real estate and fixed assets, and because the risks are greater. Substantial contribution to the welfare of the producers of these products and to the general level of local consumption has and can be made by experienced American firms who establish themselves in such countries for this purpose. That contribution should be recognized and encouraged by their unquestioned inclusion in the 14-point tax credit provision.

SUGGESTED AMENDMENT TO SECTION 923 (b) (1) (A)

Insert the words "or in carrying and merchandising products of the country without the United States" after the word "retail," so that the subsection would read:

"(A) the operation of an establishment engaged principally in the purchase or sale (other than at retail or in carrying and merchandising products of the country without the United States) of goods or merchandise, or"

Anderson, Clayton & Co., condensed consolidated position statement and credit and capital employed Jan. 31, 1954

[In thousands]

	Consolidated	Domestic	Total foreign	Subsidiaries						Branch France
				Mexico	Peru	Brazil	Argentina	Paraguay	Egypt	
Current assets:										
Cash and governments	21,356	17,733	3,623	890	380	1,559	652	15	85	42
Accounts receivable, trade	52,797	39,129	13,668	2,872	1,802	6,827	495	31	767	874
Crop loans	28,373	19,321	9,052	3,553	2,437	996			2,066	
Collections	16,166	10,984	5,182	569	109	3,600			904	
Inventories, cotton	174,432	155,025	19,407	3,227	522	11,747	524	11	3,376	
Inventories, other	85,578	52,696	32,882	11,597	526	18,984	540	171	1,064	
Total current assets	378,702	294,888	83,814	22,708	5,776	43,713	2,211	228	8,262	916
Less accounts payable, trade	40,426	26,920	13,506	2,580	3,406	6,135	210	25	797	353
Current position	338,276	267,968	70,308	20,128	2,370	37,578	2,001	203	7,465	563
Percent	(100)	(79 22)	(20.78)	(5.95)	(0 70)	(11.11)	(0.59)	(0.06)	(2.21)	(0 16)
Credit (short-term) employed	236,777	187,565	49,212	14,088	1,659	26,303	1,401	142	5,225	394
Working capital employed	101,499	80,403	21,096	6,040	711	11,275	600	61	2,240	169
Noncurrent assets:										
Property, plant and equipment	115,160	76,809	38,351	15,977	1,442	16,841	2,618	473	985	15
Other noncurrent assets	18,561	13,869	4,692	2,644	1,029	809	114	10	20	66
Total noncurrent assets	133,721	90,678	43,043	18,621	2,471	17,650	2,732	483	1,005	81
Less minority interests, deferred liabilities and reserves	12,884	5,289	7,595	5,201	132	1,447	393	73	349	
Noncurrent position	120,837	85,389	35,448	13,420	2,339	16,203	2,339	410	656	81
Percent	(100)	(70.66)	(29.34)	(11.10)	(9.94)	(13.41)	(1.94)	(9.34)	(0.54)	(0.07)
Credit (long-term) employed	55,364	39,120	16,244	6,150	1,072	7,425	1,072	188	300	37
Fixed capital employed	65,473	46,269	19,204	7,270	1,267	8,778	1,267	222	356	44
Net worth	166,972	126,672	40,300	13,310	1,978	20,053	1,867	283	2,596	213
Percent	(100)	(75 86)	(24.14)	(7 98)	(1.18)	(12.01)	(1.12)	(0.17)	(1.55)	(0.13)

The CHAIRMAN. Mr. Kaliker.

Is Mr. Kaliker present?

Mr. Murphy.

Make yourself comfortable, Mr. Murphy, and identify yourself to the reporter.

STATEMENT OF MR. RAY MURPHY, GENERAL COUNSEL, ASSOCIATION OF CASUALTY AND SURETY COMPANIES

Mr. MURPHY. Mr. Chairman, and members of the committee, my name is Ray Murphy. I am general counsel of the Association of Casualty and Surety Companies, of 60 John Street, New York.

I have filed a statement with the clerk, which I respectfully ask to be included in the record.

The CHAIRMAN. It will be included in the record.

Mr. MURPHY. And since my statement on behalf of the association will be in the record, I shall be very brief.

The association is a trade group of 112 capital stock casualty insurance and surety companies. In 1953, these companies had combined premium income in excess of $2 billion. They pay Federal income taxes at the same rate as do other types of corporations and are afforded no special tax treatment, nor privilege or exemption under present law. They desire no special consideration nor any treatment different from that given to corporations generally under the proposed new tax law. However, they find under H. R. 8300, in present form, that they would be discriminated against in four particulars.

(1) Their stockholders would be denied relief from double taxation of dividends. The reference is to section 34 (c) (1) and 116 (b).

Senator LONG. Might I ask you how much it would cost to give your association and all others this relief on double taxation of dividends?

Mr. MURPHY. I am afraid I can't answer that question.

Mr. STAM. I don't have that figure, but I might say this particular provision he is talking about was an oversight in the bill.

Senator LONG. How much does it cost to give all corporations that hold stock in other corporations and insurance companies and all those the benefit of this double taxation on dividend relief?

Mr. STAM. We will have to make a check on that. I wouldn't want to give a figure now, but we will get that figure.

The CHAIRMAN. This subject has also been rather fully presented to this committee. The staff is completely aware of the problems involved.

As I said to another witness, I am not a predicter here, and I can only speak for myself at this stage of the game, but I think the problem is being taken care of.

Mr. MURPHY. Senator, I think I will be briefer by making an extremely brief reference to them.

Senator LONG. Is there any particular reason why you were left out of all four of these provisions that were put in there, that others would benefit from?

Mr. MURPHY. As Mr. Stam has indicated, I think that with reference to the dividend matter there perhaps had been a first impression that our companies received some type of favorable consideration as compared to corporations generally.

As you know, there are different methods of taxes for different types of insurance companies. As it happens, our companies are taxed on exactly the same basis as are corporations generally, which is not true of some other types of companies.

The CHAIRMAN. In other words, your stock is the same as other stock?

Mr. MURPHY. Exactly.

(2) The dividends received credit now allowed to corporate stockholders would be eliminated with respect to dividends received by corporate stockholders of capital stock insurance companies.

I am aware that the Treasury Department and the staff of the joint committee have already given consideration to a correction of these discriminatory features, and I know that this committee has received from other groups adversely affected thereby considerable testimony.

And for that reason, and because points (1) and (2) are fully covered in my prepared statement in the record, I shall pass to the two other discriminatory features of H. R. 8300. These would deny the capital stock insurance companies.

(3) The credit provided in the section 37, with respect to business income from foreign sources—the reference being section 923 (d) (2), and

(4) Would deny the capital stock insurance companies the right to make an election with respect to the treatment provided by part IV of H. R. 8300, concerning deferred income from sources in foreign countries.

These points have also been heretofore made to this committee, and I have previously discussed them with Mr. Stam in the presence of Mr. Gimmell, at which time, Mr. Stam, while indicating points (1) and (2) heretofore mentioned and pertaining to dividends perhaps were well taken, as I trust he now feels they are, said he would like to have additional information with respect to points (3) and (4), pertaining to foreign income.

In conclusion therefore, may I say that my filed statement contains amplification as to types and dollar amounts of insurance business done by capital stock insurance companies in a considerable number of foreign countries.

Precisely the same lines of insurance, with the same kind of coverages are written by our companies abroad as are written here. The business is transacted in the same way as here, and, as here, under trict supervisory requirements created by law.

I may say I assume the theory of that part of the proposed law is to encourage American production and American business in foreign countries. And frankly, Senator, I cannot see how that business would be adequately or completely encouraged and covered, except with insurance going along as a handmaiden and as a part of it. Therefore, I see no reason why there should be any discrimination against our companies, even though the volume at this time is not huge, compared to some other forms of enterprise. It is growing all the time.

The CHAIRMAN. How many companies are in your association?

Mr. MURPHY. 112.

The CHAIRMAN. How much is the amount of premium you mentioned?

Mr. MURPHY. The amount of premium overall is in excess of $2 billion a year.

The CHAIRMAN. How many stockholders?

Mr. MURPHY. Senator, I cannot say how many stockholders. It runs into the hundreds of thousands, I would assume.

I have taken as little of the time of the committee as is possible in covering these 3 or 4 points, which were covered on April 12 by Senator Scott Lucas and other witnesses, with whom I fully concur. I have done so to emphasize the great interest which the association has in the subject matter. As the largest group of casualty and stock security companies in this country, we would be considerably remiss, I believe, if we failed to stress to this committee our interest in these provisions and our hope that what we leave with you will be given careful consideration.

We wish to assure the committee and the staff that we will be pleased, indeed, to provide any additional information we can in which they may find any interest.

The CHAIRMAN. We are very glad to have your testimony. Senator Lucas and others have made quite an impressive presentation on this, as you have.

Mr. MURPHY. Thank you.

The CHAIRMAN. Thank you very much.

(The prepared material of Mr. Murphy follows:)

MEMORANDUM SUBMITTED ON BEHALF OF THE ASSOCIATION OF CASUALTY & SURETY COMPANIES WITH RESPECT TO DISCRIMINATORY PROVISIONS OF H. R. 8300

The membership of the Association comprises 112 capital stock insurance companies engaged in the writing of casualty, surety and allied lines of insurance. A list of such membership is attached.

This memorandum is directed to the following provisions of H. R. 8300 which unreasonably and inequitably discriminate against capital stock insurance companies and their stockholders:

1. Section 34 (c) (1) and 116 (b) which deny to individual stockholders of such insurance companies the newly provided relief from double taxation of dividends;
2. Section 246 (a) (1) in which the 85 percent dividends received credit, to which corporate stockholders (including corporate stockholders of such insurance companies) are now entitled under existing law, and which the bill continues as a deduction for corporations generally, would be completely eliminated with respect to capital stock insurance company dividends received by corporate stockholders;
3. Section 923 (d) (2) which denies to such insurance companies the credit provided in section 37 with respect to business income from foreign sources;
4. Section 951 (c) (4) which denies to such insurance companies the right to make an election with respect to the treatment provided by part IV of H. R. 8300 with respect to deferred income from sources within foreign countries.

Member companies to this association, in common with hundreds of other like companies, are now subject to tax under section 204 of the Internal Revenue Code and, in accordance therewith, pay the full 30 percent normal tax and the full 22 percent surtax on their entire net income. Thus such companies, under present law, pay Federal income taxes at precisely the same rates as do manufacturing corporations, mercantile corporations, and other corporations generally.

Under the provisions of H. R. 8300, our member companies would be subject to the tax to be imposed under proposed section 831, which, in part, provides: "Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company) * * *" Section 11 imposes a normal tax of 30 percent of taxable income and a surtax of 22 percent on certain taxable income in excess of $25,000.

Thus, if H. R. 8390 is enacted, capital stock casualty and surety companies will continue to pay a Federal income tax on their entire net profits at present regular corporation income-tax rates. Such companies do not enjoy any special tax ad-

vantage of any kind under the present law and no tax advantage is granted them under H. R. 8300.

Accordingly, it is grossly inequitable and unreasonable to deny to individual stockholders of such companies the relief from double taxation newly proposed in the bill with respect to individual stockholders of corporations generally, and to take away from corporate stockholders of such insurance companies the relief from double taxation which the present law provides and which the bill would continue for corporate stockholders of other corporations generally.

In recent years, the insurance business, as well as business generally and the national economy, has grown tremendously, and all indications point to a continuation of this growth. Such growth requires and will continue to require large sums of additional capital. In fact, since the end of World War II, a number of insurance companies, large and small, have been finding it necessary to offer new stock issues to the public in order to be able to write a rapidly mounting volume of business. Obviously, the discrimination with respect to dividends paid on the stock of insurance companies would seriously impair the desirability of such stock, thereby making it difficult to acquire additional capital to meet the needs of expanding business.

Among the lines of insurance written by our member companies are workmen's compensation, automobile, aircraft, general public and miscellaneous liability and physical damage, accident and health, credit, surety and fidelity bonds, boiler and machinery, glass, and burglary and theft. It is obvious that these lines of insurance are vitally necessary to the operation of business and industry generally and directly affect the national economy. Accordingly, the national economy could be seriously affected by any curtailment in the business of writing such insurance and this curtailment could well result from an inability to acquire additional capital created by the proposed discrimination with respect to stockholders' dividends of such insurance companies.

It is, therefore, respectfully requested that section 246 be amended to continue the present 85 percent dividends received credit in the form of a deduction for corporate stockholders and that section 34 be amended to extend the benefits of the newly proposed relief from double taxation of dividends to individual stockholders of insurance companies which would be subject to the tax imposed by section 831 of H. R. 8300. It is suggested that the foregoing purposes could be acomplished by amending sections 34 (c) (1) and 246 (a) (1) to read as follows:

"(1) an insurance company (other than a stock insurance company taxable under section 831) subject to a tax imposed by subchapter L (section 801 and following) ;"

Equally inequitable and unreasonable are the discriminations against capital stock insurance companies contained in sections 923 (d) (2) and 951 (c) (4) in which such companies are denied the 14 percent credit against the United States tax for business income from foreign sources and the right to make an election with respect to deferment of foreign income under certain circumstances. Heretofore, the Congress has never discriminated against these companies. Their foreign income presently is subject to taxation for normal and surtax rates, less credits or deductions for foreign income taxes in the same manner as other corporate taxpayers.

These companies do business in foreign countries in various ways, including (*a*) directly through branch offices or agents; (*b*) through associations such as the American Foreign Insurance Association (AFIA) or American Insurance Underwriters (AIU) ; (*c*) through subsidiaries; (*d*) by participation in reinsurance transactions.

An association consists of a group of insurance companies which have pooled their resources to write business in foreign countries under the supervision of trained experts in the foreign field. Companies participate in the business written by the association on a percentage basis.

Most countries require such insurers to make substantial qualifying deposits on entry and additional deposits to cover their unearned premium and loss reserves. As these reserves increase in size, the deposit requirements also increase. It is estimated that in Canada alone casualty, surety, and fire companies have at least $200 million invested, the major part of which is deposited with the Dominion authorities for the protection of policyholders.

The business of insurance, by its very nature, is a highly important and integral part of the economic structure of the country. It is the vehicle for the credit required by other businesses and it constitutes the vital protection of the investment of those businesses in their physical assets. Very large amounts of capital are placed at risk by these insurers. Among the many lines

of insurance written by them in foreign countries are automobile and aircraft liability, public liability of every description, accident and health, workmen's compensation, fidelity and surety, fire, explosion, windstorm, ocean and inland transportation.

While complete figures for the foreign business are not available, association figures can be used to show a pattern of operation. The figures of one of the associations (AFIA) show premium writings in foreign countries for 1953 (excluding Canada) of approximately $30 million. Of that volume of premiums, there was an estimated amount at risk of $6 billion. The association has some 1,500 employees engaged abroad and in its thirty-odd years of existence has incurred approximately $165 million losses in these foreign countries. In addition, all the assets of its member companies, wherever located, are exposed to the risks of the business.

The investments of insurance companies in foreign countries include real estate, either owned or leased; deposits; payment of employees' salaries; payment of other operating expenses, including taxes; payment of insurance losses; and funds and profits which are subject to withdrawal restrictions by blocking of currency by foreign governments.

Certainly, it is both illogical and inequitable to allow the foreign income benefits in question to commercial enterprises generally and to deny those benefits to insurance companies which make possible the establishment, growth and development of such commercial enterprises. Moreover, such denial might operate to curtail the current growth of worldwide insurance written by United States companies by making it less attractive for such companies to provide a market for foreign insurance. Thus, American enterprise would tend to purchase its foreign insurance from foreign companies and the United States would be greatly hampered in developing as a major market for insurance originating in other countries.

It is, therefore, respectfully requested that this discrimination against capital stock insurance companies with respect to foreign income also be eliminated. It is suggested that this could be accomplished by amending sections 923 (a) (d) (2) and 951 (c) to read, either:

> is an insurance company (other than a stock insurance company taxable under section 831) subject to a tax imposed by subchapter L (section 801 and following),
>
> or
>
> is subject to the tax imposed by Part I or Part II of subchapter L (section 801 and following relating to insurance companies);

Respectfully submitted.

ASSOCIATION OF CASUALTY AND SURETY COMPANIES,
BY RAY MURPHY, *General Counsel.*

Association of casualty and surety companies membership list

Company	Group affiliation
Aetna Casualty & Surety Co., 151 Farmington Ave., Hartford, Conn	Aetna Life.
Aetna Insurance Co., 670 Main St., Hartford, Conn	Aetna Insurance.
Agricultural Insurance Co., Watertown, N. Y	Agricultural.
Albany Insurance Co., 55 5th Ave., New York, N. Y	Atlas.
American Automobile Insurance Co., Pierce Bldg., St. Louis, Mo	American-Associated.
American Bonding Co. of Baltimore, Fidelity Bldg., Baltimore, Md	Fidelity and Deposit.
American Casualty Co., 607 Washington St., Reading, Pa	American Casualty.
American Credit Indemnity Co. of New York, First National Bank Bldg., Baltimore, Md.	Commercial Credit.
American Employers' Insurance Co., 110 Milk St., Boston, Mass	Employers'.
American Fire & Casualty Co., American Bldg., Orlando, Fla	None.
American Guarantee & Liability Insurance Co., 135 South LaSalle St., Chicago, Ill.	Zurich.
American Insurance Co., 15 Washington St., Newark, N. J	American of Newark.
American National Fire Insurance Co., 1 Liberty St., New York, N. Y	Great American.
American Re-Insurance Co., 99 John St., New York, N. Y	American Re-Insurance.
American Surety Co. of New York, 100 Broadway, New York, N. Y	American Surety.
Associated Indemnity Corp., 332 Pine St., San Francisco, Calif	American-Associated.
Atlas Assurance Co., Ltd., 55 5th Ave., New York, N. Y	Atlas
Bankers Indemnity Insurance Co., 15 Washington St., Newark, N. J	American of Newark.
Boston Insurance Co., 87 Kilby St., Boston, Mass	Boston.
Car & General Insurance Corp., Ltd., 111 John St., New York, N. Y	Royal Exchange.
Century Indemnity Co., 670 Main St., Hartford, Conn	Aetna Insurance.
Columbia Casualty Co., 1 Park Ave., New York, N. Y	Commercial Union.
Commercial Insurance Co. of Newark, 10 Park Pl., Newark, N. J	Loyalty.
Connecticut Fire Insurance Co., 61 Woodland St., Hartford, Conn	Phoenix of Hartford.
Connecticut Indemnity Co., 175 Whitney Ave., New Haven, Conn	Security of New Haven.
Detroit Fire & Marine Insurance Co., 625 Shelby St., Detroit, Mich	Great American.
Eagle Fire Co. of New York, 75 Maiden Lane, New York, N. Y	Norwich Union.
Empire State Insurance Co., Watertown, N. Y	Agricultural.
Employers' Fire Insurance Co., 110 Milk St., Boston, Mass	Employers'.
Employers Insurance Co. of Alabama, Inc., 2112 1st Ave. North, Birmingham, Ala.	None.
Employers' Liability Assurance Corp., Ltd., 110 Milk St., Boston, Mass	Employers'.
Equitable Fire & Marine Insurance Co., 61 Woodland St., Hartford, Conn	Phoenix of Hartford.
Federal Insurance Co., 90 John St., New York, N. Y	Chubb & Son.
Fidelity & Casualty Co. of New York, 80 Maiden Lane, New York, N. Y	America Fore.
Fidelity & Deposit Co., of Maryland, Charles and Lexington Sts., Baltimore, Md	Fidelity and Deposit Group.
Fire Association of Philadelphia, 401 Walnut St., Philadelphia, Pa	Fire Association.
Fireman's Fund Indemnity Co., 401 California St., San Francisco, Calif	Fireman's Fund.
Firemen's Insurance Co., of Newark, N. J., 10 Park Pl., Newark, N. J	Loyalty.
Franklin National Insurance Co of New York, 1000 Asylum Ave., Hartford, Conn.	National of Hartford.
General Accident, Fire & Life Assurance Corp., Ltd., 414 Walnut St., Philadelphia, Pa	General Accident.
General Reinsurance Corp., 90 John St., New York, N. Y	General Reinsurance.
Girard Insurance Co., of Philadelphia, Pa., 10 Park Pl., Newark, N. J	Loyalty.
Glens Falls Indemnity Co., Glens Falls, N. Y	Glens Falls.
Glens Falls Insurance Co., Glens Falls, N. Y	Do.
Globe Indemnity Co., 150 William St., New York, N. Y	Royal-Liverpool.
Great American Indemnity Co., 1 Liberty St., New York, N. Y	Great American.
Great American Insurance Co., 1 Liberty St., New York, N. Y	Do.
Hartford Accident & Indemnity Co., 690 Asylum Ave., Hartford, Conn	Hartford Fire.
Hartford Steam Boiler Inspection & Insurance Co., 56 Prospect St., Hartford, Conn.	None.
Home Indemnity Co., 59 Maiden Lane, New York, N. Y	Home.
Home Insurance Co., 59 Maiden Lane, New York, N. Y	Do.
Home Insurance Co. of Hawaii, Ltd., 129 South King St., Box 2866, Honolulu, T. H	None.
Hudson Insurance Co. of New York, 90 John St., New York, N. Y	Skandia.
Indemnity Insurance Co. of North America, 1600 Arch St., Philadelphia, Pa	Insurance Company of North America.
London Guarantee & Accident Co., Ltd., 55 5th Ave., New York, N. Y	Phoenix of London.
London & Lancashire Indemnity Co., 20 Trinity St., Hartford, Conn	London & Lancashire.
Manufacturers Casualty Insurance Co., Pennsylvania Blvd. at 16th St., Philadelphia, Pa.	Transamerica.
Maryland Casualty Co., Maryland Casualty Bldg., Baltimore, Md	None.
Massachusetts Bonding & Insurance Co., 10 Post Office Sq., Boston, Mass	Do.
Massachusetts Fire & Marine Insurance Co., 4 Liberty Sq., Boston, Mass	Great American.
Mechanics & Traders Insurance Co., 1000 Asylum Ave., Hartford, Conn	National of Hartford.
Merchants Indemnity Corp. of New York, 225 Broadway, New York, N. Y	Merchants Fire.
Metropolitan Casualty Insurance Co. of New York, 10 Park Pl., Newark, N. J	Loyalty.
Michigan Fire & Marine Insurance Co., 1250 State St. (mail, Post Office Box 1021), Springfield, Mass.	Springfield.
Milwaukee Insurance Co. of Milwaukee, Wis., 611 North Broadway, Milwaukee, Wis.	Loyalty.
National Automobile & Casualty Insurance Co., 639 South Spring St., Los Angeles, Calif.	None.
National-Ben Franklin Insurance Co. of Pittsburgh, Pa., 120 West Ohio St., Pittsburgh, Pa.	Loyalty.

Association of casualty and surety companies membership list—Continued

Company	Group affiliation
National Fire Insurance Co of Hartford, 1000 Asylum Ave., Hartford, Conn	National of Hartford.
National Surety Corp., 4 Albany St., New York, N. Y	National Surety.
National Union Fire Insurance Co., 139 University Pl., Pittsburgh, Pa	National Union.
National Union Indemnity Co , 139 University Pl , Pittsburgh, Pa	Do.
New Amsterdam Casualty Co., 227 St. Paul St , Baltimore, Md	New Amsterdam.
Newark Insurance Co , 150 William St , New York, N. Y	Royal-Liverpool.
New England Insurance Co , 1250 State St. (mail, Post Office Box 1021) Springfield, Mass	Springfield.
North American Casualty & Surety Reinsurance Corp., 161 East 42d St., New York, N. Y.	None.
North River Insurance Co., 110 William St., New York, N. Y	Crum & Forster.
Norwich Union Fire Insurance Society, Ltd , 75 Maiden Lane, New York, N. Y.	Norwich Union.
Ocean Accident & Guarantee Corp , Ltd., 1 Park Ave., New York, N. Y	Commercial Union.
Ohio Farmers Indemnity Co., LeRoy, Ohio	Ohio Farmers.
Old Colony Insurance Co , 87 Kilby St , Boston, Mass	Boston.
Pacific Insurance Co , Ltd., 850 Kapiolani Blvd., Honolulu, T. H	None.
Phoenix Indemnity Co , 55 5th Ave , New York, N Y	Phoenix of London.
Phoenix Insurance Co., 61 Woodland St , Hartford, Conn	Phoenix of Hartford.
Providence-Washington Indemnity Co., 20 Washington Pl , Providence, R I	Providence-Washington.
Providence-Washington Insurance Co , 20 Washington Pl , Providence, R I	Do.
Prudential Insurance Co. of Great Britain, 90 John St , New York, N. Y	Skandia.
Quaker City Fire & Marine Insurance Co , 55 5th Ave., New York, N. Y	Atlas.
Queen Insurance Co. of America, 150 William St., New York, N. Y	Royal-Liverpool.
Reliance Insurance Co. of Philadelphia, 401 Walnut St., Philadelphia, Pa	Fire Association.
Rochester American Insurance Co., 1 Liberty St., New York, N. Y	Great American.
Royal Indemnity Co., 150 William St., New York, N. Y	Royal-Liverpool.
St. Paul-Mercury Indemnity Co., 111 West 5th St., St. Paul, Minn	St. Paul Fire & Marine Group.
Seaboard Surety Co., 75 Maiden Lane, New York, N. Y	None.
Security Insurance Co. of New Haven, 175 Whitney Ave., New Haven, Conn	Security of New Haven.
Service Casualty Co. of New York, 1 Park Ave., New York, N. Y	Service.
Skandia Insurance Co., 90 John St., New York, N. Y	Skandia.
Springfield Fire & Marine Insurance Co., 1250 State St. (mail, Post Office Box 1021), Springfield, Mass.	Springfield.
Standard Accident Insurance Co., 640 Temple Ave., Detroit, Mich	Standard of Detroit.
Standard Insurance Co. of New York, 100 William St , New York, N. Y	Aetna Insurance.
Sun Indemnity Co. of New York, 55 5th Ave., New York, N. Y	Sun of London.
Transcontinental Insurance Co., 1000 Asylum Ave., Hartford, Conn	National of Hartford.
Travelers Indemnity Co., 700 Main St., Hartford, Conn	Travelers.
Travelers Insurance Co., 700 Main St , Hartford, Conn	Do.
Tri-State Insurance Co., 619 South Main St., Tulsa, Okla	Tri-State.
United National Indemnity Co., 1000 Asylum Ave., Hartford, Conn	National of Hartford.
United States Casualty Co., 60 John St., New York, N. Y	New Amsterdam.
United States Fidelity & Guaranty Co., Calvert and Redwood Sts., Baltimore, Md.	United States Fidelity & Guaranty.
United States Fire Insurance Co., 110 William St., New York, N. Y	Crum & Forster.
Westchester Fire Insurance Co , 110 William St., New York, N. Y	Do.
World Fire & Marine Insurance Co., 670 Main St., Hartford, Conn	Aetna Insurance.
Yorkshire Insurance Co , 90 John St., New York, N. Y	Yorkshire.
Zurich General Accident & Liability Insurance Co., Ltd., 135 South La Salle St., Chicago, Ill.	Zurich.

The CHAIRMAN. Is Mr. Kaliker here?

Mr. KALIKER. Yes, sir.

The CHAIRMAN. Come forward, please. Make yourself comfortable and identify yourself to the reporter, please.

STATEMENT OF ALVIN K. KALIKER, TAX DEPARTMENT MANAGER, WAYNE PUMP CO.

Mr. KALIKER. My name is Alvin F. Kaliker, of the Wayne Pump Company Tax Department, Salisbury, Md.

Mr. Chairman, and members of the committee, I apologize first of all for being absent from the room when my name was called. Senator Capehart had asked me to come to see him and he would accompany me to the hearing, but he was too busy with his FHA hearing. That is the reason I was out of the room.

The CHAIRMAN. We are very glad to have you here, late or not.

Mr. KALIKER. Thank you, Senator.

We were before this committee about 3 years ago on the same problem as we are here on now, and we have a prepared, typed statement that I have submitted to the committee, and I would rather not read it and just make a few oral remarks if I may.

The CHAIRMAN. You may do that, and your formal address will be included in the record.

Mr. KALIKER. Briefly our problem is receiving foreign dividends in the same year in which we have an operating loss. And, we lost the foreign tax credit because of that combination of two disadvantages taking place at the same time. It happened to us in 1947 and 1948, and then in 1950 and 1951 we had profit years, and it occurred again to us both in 1952 and 1953, and in a still greater degree of loss than it did in the 2 years, 1949 and 1950.

We have a remedy in the form of a bill or amendment that we have submitted to the joint technical staff on Federal taxation, Mr. Stam, that will give relief to our situation.

There are two main points:

First, the credit should be given to loss corporations or businesses, if the theory of foreign tax credit is right in the first place.

And, the second point is that the theory that we are asking for, carry-back and carry-forward of a foreign tax credit, is not a new theory. The operating loss carry-back and carry-forward has been in effect for some years and the unused profit, excess profits credit, carry-back and carry-forward, which is now extinct, had that theory and feature in it.

And, you might say: Why do you have the dividends come over in a loss year? We cannot control that. The same forces that have caused us to have an operating loss in this country operate to make you want to get those dividends over in that year more so than when you have a profit year. And so we are helpless in that respect.

I find that a few days ago the American Institute of Accountants made a recommendation before this committee, and in that we are not the only sufferers from this inequity.

I would like to quote what they say:

The foreign credit should be carried back and forward to prevent it being lost completely in cases where the domestic parent has a loss in the year in which the foreign dividend is received.

May I also call to your attention that this deficiency in the present bill must have come to the attention of the accountants because of the harm that this inequity is causing certain of their clients.

I believe that the revenue loss or effect on the budget, comparatively speaking, would be pennies, in that respect, but would become dollars to the suffering business corporations or any other individual business at that particular time who right now need the help, when they are having losses.

I believe that is all I have to say, Mr. Chairman, and gentlemen.

I thank you for the privilege and courtesy of listening to me.

The CHAIRMAN. We are glad to have you. Thank you very much.

(The statement of Mr. Kaliker follows:)

My name is Alvin F. Kaliker, Tax Department Manager of the Wayne Pump Co.

The Wayne Pump Co. is engaged in the manufacture and sale of gasoline filling station equipment, hoists, air compressors, hose reels, airport equipment and related items. It is also engaged extensively in defense work. Its factory and

executive offices are in Salisbury, Md., and it has divisions in Fort Wayne, Ind., Ironton, Ohio and Toronto, Canada. It also has two wholly owned foreign subsidiaries, 1 in England and 1 in Brazil.

The company has been in existence since 1891.

The problem that confronts the Wayne Pump Co. has to do with the tax treatment of income received from its foreign subsidiaries, in particular relation to H. R. 8300, now before this committee for examination. Our problem arises from section 902 of H. R. 8300, and was present also under the provisions of the predecessor section 131 (f) of the present Internal Revenue Code. The new section 902 thus perpetuates an inequity which exists in the present code. We requested relief from this inequity before this committee while it was deliberating the Revenue Act of 1951, and I hope you will understand our difficult situation which causes me again to call it to your attention.

Section 902 permits a credit against the United States tax of a domestic corporation for foreign taxes paid by a foreign subsidiary from which it receives dividends.

The unfairness to us of section 902 lies in the fact that it permits such credit only in years in which the domestic corporation has a profit and is paying a domestic tax—whereas in domestic loss years, such as we suffered in 1952 and 1953, the credit is, in effect, completely lost to us. This is because the credit for the foreign tax paid on the foreign dividends can be applied only against a domestic tax paid.

On the other hand, under section 902, even though no credit for taxes on foreign dividends is applicable to the domestic corporation in a loss year, it suffers an additional penalty due to the foreign dividends received. This is for the reason that the company must reduce any net operating loss carryback or carryover by the amount of the dividends received. It would seem only fair to allow a carryback or carryover of the credit for the foreign tax paid on such dividends—but the law forbids this. In other words we really suffer a double disadvantage in a loss year, by (1) the amount of reduction in our loss carryover represented by the foreign dividends received, and (2) the actual loss of any credit for foreign taxes thereon.

The effect that this provision has had on the finances of the Wayne Pump Co. in the last 6 years may be seen in the following table.

Illustrating amount of foreign tax credit lost due to having foreign income and a domestic operating loss in the same year

Fiscal year ended November 30—	Per Federal return as field		Net foreign income included in the return	Foreign tax credit lost (under present law)
	Net taxable income	Federal tax		
1948	[1] 490,000	None	$137,000	$52,000
1949	110,000	None	174,000	25,000
1950	855,000	$256,000	204,000	
1951	366,000	88,000	147,000	
1952	[1] 296,000	None	165,000	82,500
1953	[1] 140,000	None	205,000	102,000

[1] Loss.

We feel that it is wrong to give a benefit to a corporation which is operating at a profit and deny it to a corporation which is operating at a loss. We also feel that this can be remedied with a relatively insignificant effect upon the Federal revenue.

We propose that a domestic corporation that is eligible for a credit for foreign taxes paid on dividends received from its foreign subsidiary in all respects, except for the one fact that in the year the dividends are received it does not have a domestic tax against which to apply the credit—be permitted to carry back or forward the amount of the credit to the first year in which the company operates at a profit that requires payment of a domestic tax.

Apparently we are not the only sufferers from this inequity. In its testimony before this committee on Monday of this week, the American Institute of Accountants made the following recommendation:

"The foreign tax credit should be carried back and forward to prevent it from being lost completely in cases where the domestic parent has a loss in the year in which the foreign dividend is received."

May I commend to you the recommendation stated so clearly and succinctly by the accountants. May I also call to your attention that this deficiency in H. R. 8300 must have come to the attention of the accountants through the harm that this inequity is causing their clients.

We have drawn up a proposed amendment to cover this recommendation, and have referred it to the technicians on the Staff of the Joint Committee on Internal Revenue Taxation. We hope that you will recognize its merit.

In the event that the committee feels it cannot grant carryback and carryover treatment to such foreign credits, then in the alternative we would be helped by an amendment that would give some relief, although it would be considerably less than the carryback-carryforward relief requested. This alternative relief would consist in permitting such corporations to elect to deduct the amount of taxes paid on the foreign dividends received rather than to take a credit for the amount paid. Since the deduction would apply against our gross income and the credit would apply against our tax, the credit would be considerably more helpful to our situation. However, in a year in which there is no tax against which to apply it, the credit is worth nothing; and the deduction, small though it may be, could be carried back or forward and to that extent minimize the amount by which our net operating loss would be reduced in any year in which we receive dividends from one or both of our foreign subsidiaries.

We thank you for the privilege of appearing before you and for your courtesy in listening.

The CHAIRMAN. Mr. Whitman, please.

Make yourself comfortable and identify yourself to the reporter. We are glad to see you.

STATEMENT OF F. B. WHITMAN, PRESIDENT, THE WESTERN PACIFIC RAILROAD CO.

Mr. WHITMAN. Mr. Chairman, members of the committee, my name is Fredrick B. Whitman. I am president of the Western Pacific Railroad Co., which is a class I railroad operating in the States of Utah, Nevada, and California. Our railroad serves the country as an active link in the transcontinental transportation system.

The CHAIRMAN. What is your present connection with the Rio Grande?

Mr. WHITMAN. We have a present connection with them at Salt Lake, but we have no relation to the Rio Grande, other than we are good friends and exchange business.

The CHAIRMAN. Thank you very much.

Mr. WHITMAN. There are several sections of H. R. 8300 which, if enacted, would work vast hardships on us. I cannot in 10 minutes' time do more than show the vital necessity, not only to us but also in the interests of a healthy national economy, that there be made inapplicable to us and to all regulated carriers and utilities the provisions of H. R. 8300 designated as section 275, subchapter C of chapter I of subtitle A in its entirety; and section 461.

The mechanics of the relief I urge have been set out in detail in a written memorandum which I request to be incorporated in the record for study and analysis by your staff and for subsequent report to you in your executive deliberations.

The CHAIRMAN. That will be done.

(The information referred to follows:)

STATEMENT OF MR. F. B. WHITMAN, PRESIDENT, THE WESTERN PACIFIC RAILROAD COMPANY

My name is Frederic B. Whitman. I am president of the Western Pacific Railroad Co. which is a class I railroad operating in the States of Utah, Nevada, and

California. Our railroad serves the country as an active link in the transcontinental transportation system.

There are several sections of H. R. 8300 which, if enacted, would work vast hardship on us.

I cannot in 10 minutes' time do more than show the vital necessity, not only to us but also in the interests of a healthy national economy, that there be made inapplicable to us and to all regulated carriers and utilities the provisions of H. R. 8300 designated as—section 275; subchapter C of chapter I of subtitle A in its entirety; and section 461.

The mechanics of the relief I urge have been set out in detail in a written memorandum which I request be incorporated in the record for study and analysis by your staff and for subsequent report to you in your executive session deliberations.

However, in the time allotted to me, I hope to bring into focus the plight in which these provisions of H. R. 8300 would place the railroad industry and to submit to you the reasons why I believe they should be made inapplicable to us.

First. As to the nondeductibility of interest on income bonds and income debentures: I do not know to what "tax-dodging" uses these securities have been put in the unregulated corporation field, but in our regulated industry they are a wholly sound and stabilizing component of our debt structure. In our industry there is no element of profit sharing at the whim of a board of directors nor is there uncontrolled discretion in payments of interest on such income bonds. Interest is mandatorily paid under rigid formulae for each year in which earned. Furthermore, principal amounts are unconditionally due and payable at fixed maturity dates. By every reasonable test known to me, these income debentures and mortgage bonds are true debt instruments. The great advantage of the income bond is that it wholly and completely insures against the disaster of bankruptcy because of a default resulting from one or more years' failure to earn interest. Over a billion dollars worth of income obligations are now outstanding. There is a seasoned market for them. Like the income bonds we issued in 1944, most of such obligations were designed and approved as in the public interest by the Interstate Commerce Commission. Likewise, as in our case in 1944, most of them were issued directly or indirectly to replace fixed interest obligations whose default had brought on bankruptcy.

In the public interest the opportunity to draw from this pool of available investment funds should be kept open to the railroads. Western Pacific recently initiated a refinancing program which contemplated the obtaining of some very needed default-proof funds, but the threat of enactment of section 275 has effectively tabled our program. We urge that section 275 be stricken or made inapplicable to regulated carrier and utility corporations.

Further, we contemplate the sale of some equity investments to meet the capital construction expansion needs of our road. To do this, we planned the issuance of common stock but, first to make our common stock attractive to the investor, we must call or somehow eliminate a preferred stock issue of about $30 million. As was the case with railroads operating more than 40 percent of the railroad mileage of America, our company went through bankruptcy from 1935 to 1944. Our preferred stock had a market price of about 60 when issued. Thus the preferred stock did not pay out the face value of the old first mortgage bonds they replaced. If we now call that preferred stock, H. R. 8300, section 309, probably lays on us a penalty transfer tax of about $35 a share. Why? We are not passing surplus to shareholders so that they can dodge surtaxes. Nor is this proposed redemption a "preferred stock bail-out." In the regulated railroad and utility corporation field, I do not remember a preferred or common stock dividend bail-out in the last 20 years. It is my belief that the 1939 code provisions have operated fairly in the regulated corporation field both as to Treasury and taxpayer. My tax advisers tell me there are many obstacles to normal refinancings which contain no elements of tax doging in sections 301, 302, 305, 312, 331–336, etc., as well as in section 309 and, therefore, I urge that subchapter C entitled "Corporate Distributions and Adjustments," in its entirety, be made inapplicable to railroads.

Finally, we find under section 461 that we will have a major dislocation in our 1954 taxable income, all due to a bookkeeping change to be forced upon us by H. R. 8300. The amounts we have paid in real property taxes have been about the same over the last few years (although rising slowly due to increase in assessments and tax rates). It appears they will not materially change in 1955 or during the next few years. Under the 1939 code, we were allowed 12 months' taxes against 12 months' income in 1953 and every year prior thereto. Under H. R. 8300, we would be required to take 12 months' taxes for 1954–55 against

12 months, 6 in 1954 and 6 in 1955, and ensuing years, but the shift from the lien-date basis to a benefit-period basis of accrual will eliminate or reduce the deductions from the amounts of taxes accruing and paid in 1954 by $539,500. I am not at all sure that it is any improvement to make such a shift. Furthermore, I submit that it is an unrealistic and nonfactual burden to put upon us solely in order that the Treasury may have a new uniform rule instead of the old uniform rule. We urge that section 461 be stricken in its entirety and that as a minimum of relief as to this matter, its provisions be made optional and elective and the taxpayer be given the right to continue filing under the 1939 code provisions.

In a bill of the size and scope of H. R. 8300 it is of course impossible to prevent omissions and often unintentional discriminations whch become apparent only on close study by those affected. With the changes in the bill which we have suggested for the protection of the regulated carriers and utilities, we believe the new revenue code will be a very fine piece of legislation and a forward step.

Mr. WHITMAN. However, in the time allotted to me, I hope to bring into focus the plight in which these provisions of H. R. 8300 would place the railroad industry and to submit to you the reasons why I believe they should be made inapplicable to us.

First, as to the nondeductibility of interest on income bonds and income debentures:

I do not know to what "tax-dodging" uses these securities have been put in the unregulated corporation field, but in our regulated industry they are a wholly sound and stabilizing component of our debt structure.

Senator LONG. As far as you are concerned, doesn't that amount to a case of triple taxation? In other words, taxing the interests and taxing the corporation income and then taxing the individual income?

Mr. WHITMAN. That's right.

In our industry there is no element of profit sharing at the whim of a board of directors, nor is there uncontrolled discretion in payments of interest on such income bonds. Interest is mandatorily paid under rigid formulas for each year in which earned. Furthermore, principal amounts are unconditionally due and payable at fixed maturity dates.

The CHAIRMAN. I think you will find we will probably give some relief on that.

Mr. WHITMAN. Fine.

The CHAIRMAN. There is a very intensive study on by the staff and I have a hunch the committee will be sympathetic with the position you are taking.

Mr. WHITMAN. I'm glad to hear that.

The CHAIRMAN. Don't count too much on it, because there are 15 men here and when we have a showdown you can't tell what the views will be.

Senator LONG. In my impression, when you have the favor of the chairman on this committee you are in very good shape.

Mr. WHITMAN. By every reasonable test known to me, these income debentures and mortgage bonds are true debt instruments. The great advantage of the income bond is that it wholly and completely insures against the disaster of bankruptcy because of a default resulting from 1 or more years' failure to earn interest. Over a billion dollars worth of income obligations are now outstanding. There is a seasoned market for them. Like the income bonds we issued in 1944, most of such obligations were designed and approved as in the public interest by the Interstate Commerce Commission. Likewise, as in our case in 1944, most of them were issued directly or indirectly to replace fixed interest obligations whose default had brought on bankruptcy.

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Further, we contemplate the sale of some equity investments to meet the capital construction expansion needs of our road. To do this, we planned the issuance of common stock, but first to make our common stock attractive to the investor, we must call or somehow eliminate a preferred stock issue of about $30 million. As was the case with railroads operating more than 40 percent of the railroad mileage of America, our company went through bankruptcy from 1935 to 1944. Our preferred stock had a market price of about 60 when issued. Thus, the preferred stock did not pay out the face value of the old first mortgage bonds they replaced. If we now call that preferred stock, H. R. 8300, section 309, probably lays on us a penalty transfer tax of about $35 a share. We are not passing surplus to shareholders so that they can dodge surtaxes. Nor is this proposed redemption a "preferred stock bailout." In the regulated railroad and utility corporation field——

The CHAIRMAN. I think that is being worked on, although again I can't promise it.

Mr. WHITMAN. Thank you.

I do not remember a preferred or common stock dividend bailout in the last 20 years. It is my belief that the 1939 code provisions have operated fairly in the regulated corporation field both as to Treasury and taxpayer. My tax advisers tell me there are many obstacles to normal refinancings which contain no elements of tax dodging in sections 301, 302, 305, 312, 331, to 336, et cetera, as well as in section 309 and, therefore, I urge that subchapter C entitled "Corporate Distributions and Adjustments," in its entirety, be made inapplicable to railroads.

Finally, we find under section 461 that we will have a major dislocation in our 1954 taxable income, all due to a bookkeeping change to be forced upon us by H. R. 8300. The amounts we have paid in real property taxes have been about the same over the last few years, although rising slowly due to increase in assessments and tax rates. It appears they will not materially change in 1955, or during the next few years. Under the 1939 code, we were allowed 12 months' taxes against 12 months' income in 1953 and every year prior thereto.

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In a bill of the size and scope of H. R. 8300, it is, of course, impossible to prevent omissions and often unintentional discriminations which become apparent only on close study by those affected. With the changes in the bill which I have suggested for the protection of the regulated carriers and utilities, we believe the new revenue code will be a very fine piece of legislation and a forward step.

Thank you very much for having the opportunity to appear before the committee.

The CHAIRMAN. Thank you.

Mr. Laylin.

Make yourself comfortable, Mr. Laylin, and identify yourself to the reporter.

STATEMENT OF CLARENCE D. LAYLIN, COUNCIL OF STATE CHAMBERS OF COMMERCE

Mr. LAYLIN. My name is Clarence D. Laylin. I live in Columbus, Ohio, and am counsel for the Ohio Chamber of Commerce, and I am speaking for that chamber, and also for 16 other State chambers, which are members of the Council of State Chambers of Commerce.

I would like to file for the record a short statement, if I may, and make an even shorter oral summary of it.

The CHAIRMAN. Good.

Mr. LAYLIN. The names of these 16 are listed in the statement.

We believe H. R. 8300 should by all means become a law. It is a remarkable feat of codification and draftmanship. It embodies numerous reforms which are beneficial to the taxpayer. It removes many inequities, administrative and compliance difficulties. Its relatively few serious deficiencies, we think, can and should be removed without impeding the progress toward final enactment and approval.

I think I ought to mention the fact, Mr. Chairman, that the chambers for which I am speaking filed statements before the House Ways and Means Committee, advocating reforms a little more sweeping than are included in the bill, such as more extensive measures of alleviation of the double taxation of corporate earnings; more complete taxpayer discretion with respect to the rate and methods of depreciation; a little further relief in respect to unreasonable corporate accumulations; some rate adjustments in the field of estate and gift taxes, and so forth. And I wish to state that although the bill falls short of our hopes in these regards, that we are not complaining, because the principles for which these State chambers have long stood are recognized in the bill.

We did ask for the elimination or repeal of the 2-percent tax on consolidated corporate returns and the elimination of what amounts to the tax on 15 percent of intercorporate dividends. We are disappointed that those reforms didn't get into the bill. We still press for it.

The extension of the 52-percent corporate rate was a disappointment to these State chambers, because they had for some time firmly opposed such a rate in principle, being convinced that it was very much too high.

However, on the premise that the need for this revenue is imperative, and on the assurance that, absent some supervening crisis, the rate will be lowered after 1 year, as the bill provides, we go along with that.

The CHAIRMAN. I am not sure that assurance can be double-riveted, but I hope it will be such, when we consider it again, that there will be a reduction. Personally, I don't want to get myself fastened to that.

Mr. LAYLIN. Thank you for that measure of assurance, Mr. Chairman.

We do object seriously to the new provisions of the bill for declaration and advance payments of income taxes by certain corporations. Perhaps the objections are familiar to you, Mr. Chairman, as we see them. It means that during the 5-year adjustment period, the actual tax payments of these corporations will exceed their liabilities by substantial amounts.

We haven't undertaken to calculate the exact percentage. And that would be in addition to the increase in the burden imposed upon all corporations by the continuance of the 52-percent rate.

Second, the requirement of making such payments would seriously impair working capital.

Third, that introduces new compliance problems for the taxpayers, and new administrative problems for the Treasury.

We understand the object of it, which is to solve the debt-management problems created by the Mills Act of 1950. Of course, we suggest that a return to the original plan that would cure the defect in the system, and if that were impossible, because of immediate revenue requirements, we remind the committee that when similar action was taken with respect to the individuals, there was a partial forgiveness of the prior years' tax, which might be another alleviation of this rather drastic requirement.

I am authorized to mention a few provisions of the bill which call for corrective amendments, as we see it, and upon which there is substantial agreement among these State chambers, without pretending to indicate that they are more important than others which might be mentioned.

One of these is the application of the key employee test of a nondiscriminatory pension profit-sharing, and so forth, plan, to all seven of the permissible classifications which are listed in section 501 (e) (3) (A) of the bill. This provision, as drawn, would make it impossible for many employers having a moderate number of employees to qualify a plan which, for example, would benefit its salaried employees. That is a permissible classification, and I think you can see the mathematics of it. It would be practically impossible in many instances to qualify it under the provisions of the bill. Our suggestion is that the key employee test be applied to only the seven general classifications, and that the subsection be rewritten accordingly.

The CHAIRMAN. I may say that our staff has been working on that very intensely. Some of the inequities of the provision that is proposed are recognized, and we are going to get it into a more acceptable shape.

Mr. LAYLIN. Thank you, sir.

Most of the chambers would also prefer that section 505—I think I heard that mentioned this morning—that provides in detail for the permissible investments of such a trust. Most of them think that ought to go out.

The CHAIRMAN. That is another subject that is being considered.

Mr. LAYLIN. I am bound to say the Ohio Chamber of Commerce, which I directly represent, is not objecting to that particular provision.

Ohio does object to the elaborate qualifications of the bill as applied to group insurance plans for employees and to the tactics of payments to employees under such group insurance plan.

Now, I think I heard you, Mr. Chairman, say to a previous speaker that work was being done on section 309. Our great objection to that is 309 (c), which we think is intolerably harsh, inasmuch as it makes the transfer tax applicable to the redemption of nonparticipating stock issued prior to January 1, 1954.

The CHAIRMAN. I think there is a fair chance for that.

Mr. LAYLIN. And we have other suggestions with respect to 309 which I shall not mention orally, as they are in our statement.

Another feature of the bill to which objection is made is the new 25 percent, or you might say the 25.04 percent, rule of section 359 (b) (2) and (c) (1), qualifying the tax-free exchange of property in closely held stock of the acquiring corporation. That change of law which has been in effect for 30 years——

The CHAIRMAN. There is considerable question about that, and we may leave that out, also.

Mr. LAYLIN. There is no question about it.

The CHAIRMAN. We are having an extraordinarily easy job here.

Mr. LAYLIN. I appreciate it. Our chamber of commerce has a general recommendation that some of the technical changes which the bill would make would be effective no earlier than a reasonable time after the enactment, in order that it may not have disturbing retroactive effects upon transactions presently underway.

Now, Mr. Chairman, I am advised that a separate written statement on behalf of the Pennsylvania State Chamber of Commerce has been prepared which expresses views which are not inconsistent with those that I have expressed, and I am authorized to request that if the Pennsylvania statement is received in time, it may be filed as an appendix to the written statement which I have already filed.

The CHAIRMAN. If it is received in time, we will do that.

Thank you very much.

Mr. LAYLIN. Thank you very much.

The CHAIRMAN. Thank you very much.

(Mr. Laylin's prepared statement follows:)

STATEMENT OF CLARENCE D. LAYLIN, COLUMBUS, OHIO, ON BEHALF OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AND THE OHIO CHAMBER OF COMMERCE

Mr. Chairman and Senators, My name is Clarence D. Laylin. I live in Columbus, Ohio, and am counsel for Ohio Chamber of Commerce. I am authorized to speak for Ohio chamber and also for 16 other State chambers which are members of the Council of State Chambers of Commerce. These are: Arkansas State Chamber of Commerce, Connecticut Chamber of Commerce, Delaware State Chamber of Commerce, Florida State Chamber of Commerce, Idaho State Chamber of Commerce, Illinois State Chamber of Commerce, Indiana State Chamber of Commerce, Kansas State Chamber of Commerce, Maine State Chamber of Commerce, Missouri State Chamber of Commerce, New Jersey State Chamber of Commerce, the Empire State Chamber of Commerce (New York), Chamber of Commerce of the State of Oklahoma, South Texas Chamber of Commerce, West Virginia Chamber of Commerce and Wisconsin State Chamber of Commerce. In all, 31 State and regional bodies are affiliated in the loose federation known as the Council of State Chambers of Commerce. Each member chamber is autonomous and each determines its policies in a manner prescribed by its own constitution, which, in many instances, is a time-consuming process. Many of them, therefore, have presumably been unable, since H. R. 8300 passed the House, to complete consideration of this comprehensive measure.

For example, I am advised that a separate written statement on behalf of the Pennsylvania State Chamber of Commerce has been prepared and that the views expressed therein are not inconsistent with the views expressed in this statement. I am authorized to request that the Pennsylvania statement, if ready in time, may be filed as an appendix hereto.

I am confident, however, that all the State chambers would support the bill, because it contains many provisions which move in the direction of reforms to which every member State chamber has been committed by long-standing resolutions.

H. R. 8300 should by all means become a law. It is a remarkable feat of codification and draftsmanship. It embodies numerous reforms in the structure of the Federal tax laws, and is beneficial to all taxpayers, by removing many inequities and administrative and compliance difficulties. Its relatively few serious deficiencies can and should be corrected without impeding its progress toward final passage and approval.

On behalf of the Federal Finance Committee of the Council of State Chambers of Commerce, and of several of the separate State chambers, statements were submitted to the Committee on Ways and Means of the House of Representatives relative to the following subjects:

1. *Double taxation of corporate earnings.*—The statement made to the House advocated the alleviation of this evil by allowing to the shareholder a credit against the tax of a percentage of his dividend income, without refund. This is one of the two methods which H. R. 8300 adopted (the other being the exemption or deduction from taxable income of a limited amount of dividend income); and, because the principle is thus established, the State chambers for which this statement is made strongly favor the bill in this respect, although most of them had recorded a recommendation that the percentage of the credit should be equal to the starting rate on individual net incomes, although Canada has recently given a credit of 20 percent, and although they cherish the hope that ultimately the degree of reform for which they have stood will be achieved.

2. *Depreciation.*—The statements heretofore submitted recommended complete taxpayer discretion, within the limits of sound and consistent accounting, as to the method and the rate of accrual. The bill does not measure up to that recommendation; but it does afford some reasonably liberal and definite standards which tend to remove this troublesome problem from the area of controversy. So, while I could not say that the depreciation provisions are completely satisfactory to us, we recognize the step forward, and continue to look forward to the time when the full degree of reform in which we believe may be realized.

3. *Accumulated earnings tax.*—The position of the State chambers has been that the burden of proof as to the reasonableness of the accumulation should rest upon the Government; that credit should be given for distributions made on or before the 15th day of the third month after the close of the taxable year; that the tax base be limited to the amount found to have been unreasonably accumulated; and that the tax be denominated as a penalty. H. R. 8300 embodies the first two of these recommendations, with some qualifications, but not the third or the fourth. On the other hand, the bill excludes publicly held corporations from the tax, permits reasonably anticipated needs of the business to be recognized, and provides a deduction of $30,000 from the tax base, all of which provisions move in the right direction.

4. *Estate and gift taxes.*—In addition to the simplification of the structure of the estate tax which the bill achieves, the State chambers have heretofore recommended certain reductions and adjustments in the rates of these taxes, which perhaps would be inappropriate in a measure of the nature of H. R. 8300.

The new 66⅔ percent restriction imposed by section 2032 of the bill upon the exercise of the election to have the property in the gross estate valued as of a date later than the death of the decedent would produce incongruous and discriminatory results, and even disaster, in conceivable cases. While the writer has not been formally authorized to refer to this matter, it is believed to be appropriate to suggest that this limitation be removed, and the present law in that regard be continued in force.

CONSOLIDATED RETURNS AND INTERCORPORATE DIVIDENDS

The statement which was filed with the Ways and Means Committee of the House of Representatives advocated the elimination of the 2 percent penalty tax on the filing of consolidated returns and full, instead of 85 percent, credit for intercorporate dividends. Neither of these reforms has found place in H. R. 8300. The committee report (p. 87) seems to recognize their merit, but

states that: "Elimination of these two provisions is not believed appropriate at this time in view of present revenue needs."

We respectfully submit that the revenue effect of these long overdue reforms should not outweigh their inclusion in this revision, and suggest that the bill be amended accordingly, in line with the recommendation of the President in his budget message.

EXTENSION OF 52 PERCENT CORPORATION TAX RATE

The hearings in the House did not foreshadow two features of the bill relating to corporation income taxes. One is the extension for 1 year of the 52 percent combined corporate rate. We have been firmly opposed to this in principle, being convinced that a rate of this magnitude is much too high. However, on the premise that the need for this revenue is imperative, and on the assurance that, absent some supervening crisis, the rate will be lowered after a year, as the bill provides, we are willing to accept the extension.

DECLARATION AND ADVANCE PAYMENT OF CORPORATE TAXES

The new provisions of the bill for declaration and advance payments of income taxes by certain corporations are very objectionable. In brief, the objections are: First, during the 5-year adjustment period the actual tax payments of these corporations will exceed their liabilities by substantial amounts in addition to the increase in the burden imposed upon all corporations by the continuation of the 52 percent rate; second, these payments would seriously impair working capital; and third, the plan introduces new compliance problems for the taxpayers and new administrative problems for the Treasury. We recognize that the bill seeks at this point to solve the debt-management problems created by the Mills bill of 1950. We suggest that a return to the original plan of corporate payments would cure this defect in the present system; and, if immediate revenue requirements will not permit that solution, that the drastic impact of the acceleration be mitigated by forgiveness of a part of each prior year's liabilities during the 5-year period, as was done when individuals were placed on a current payment basis.

I am authorized to mention a few provisions of the bill which call for corrective amendments upon which there is substantial agreement among us, without intending to indicate that they are more important than others to which allusion might be made.

PENSION, PROFIT-SHARING, ETC., PLANS

In general, the revision and liberalization of the laws applicable to pension, profit-sharing, stock bonus, and accident and health plans which H. R. 8300 embodies are commendable and in line with previous recommendations of the State chambers. Certain details, however, are open to serious objection and, we think, should be corrected by amendment.

One of these is the application of the "key employee" test of a nondiscriminatory plan to all seven of the permissible classifications listed in section 501 (e) (3) (a) of the bill.

This provision, as drawn, would make is impossible for many employers having a moderate number of employees to qualify a plan which would, for example, benefit its salaried employees. Our suggestion is that the key employee test be applied only to the seventh, or general, classification, and that the subsection be rewritten accordingly.

Another is the inclusion in the bill of section 505, providing in detail for the permissible investments of such a trust. This section projects the Government into the role of an investment counselor, thus increasing the burdens of administration of and compliance with the tax law; it seems unnecessary as a safeguard, in view of the general provision of section 504 (a) (3) and the principles governing investment of trust funds to be found in the law of every State. So, nearly all of the State chambers would recommend that section 505 be deleted. However, my own chamber, Ohio, finds certain good features in the section, and does not object to it.

The Ohio Chamber does, however, take exception to the various provisions of the bill which, together, have the effect of subjecting employees group accident and health insurance plans to the qualification provisions which apply to pension and other employee benefit arrangements; and is opposed to the taxation of payments to employees under such group insurance plans.

THE ANTI-BAIL-OUT TRANSFER TAX (SEC. 309)

The very thoroughgoing revision of the law which is made by subchapter C of chapter 1 of H. R. 8300, relating generally to corporate distributions and adjustments engenders numerous questions and some criticisms. Without prejudice to any of these, the State chambers have given attention to two notable substantive changes in existing law.

First, section 309 of the bill seeks to close what is called the bail-out loophole by imposing a transfer tax on a corporation redeeming its nonparticipating stock within 10 years after its issuance. Without attempting to summarize the effect of this section in relation to the corporate distribution provisions of sections 301 and 302, we call attention to subsection (c) of section 309. This would impose the tax upon the redemption of stock issued prior to January 1, 1954, at any time prior to January 1, 1964. Such a provision seems to us to be intolerably harsh, as it frustrates financing arrangements made in good faith, by attaching unforeseen consequences to them. We recommend the deletion of this subsection and the substitution of a provision to the effect that the tax be confined to the redemption of stock issued after the enactment of the bill into law. Inasmuch as the evil to be remedied—the avoidance of tax on dividend income—is one which occurs most frequently, if not exclusively, in the cases of closely held corporations, we suggest consideration of the advisability of limiting the coverage of the transfer tax to such corporations. Ohio also suggests consideration of possibility of the elimination of the transfer tax as such, and, by amendments of other sections designed to protect innocent investors, subjecting amounts received upon redemption of nonparticipating stock to taxation as dividend income in the hands of the recipients.

CORPORATE ACQUISITIONS OF STOCK OR PROPERTY (SEC. 359 (b) (2) AND (c) (1))

Second, by imposing the 25 percent—400 percent condition upon the tax-free exchange of stock or property of a closely held corporation for stock of the acquiring corporation, as provided by section 359 (b) (2) and (c) (1), the law as it has stood for more than thirty years would be changed. We see no good reason for the change. To the assertion that such limitations serve to distinguish what is in effect a sale from what is properly regarded as a merger or other reorganization, the answer, we think, is twofold: First, that the line is an arbitrary one, and second, that the distinction sought to be drawn is irrelevant to any principle of taxation or long-range revenue objective. The State chambers find these provisions very objectionable and recommend their elimination.

Finally, Ohio Chamber of Commerce recommends that further consideration be given to the effective dates of the technical changes in the law which the bill would make. Some of these changes should not be made effective earlier than a reasonable time after the enactment of the bill, lest they have a disturbing retroactive effect upon transactions under way.

(The following letter was subsequently furnished for the record:)

PENNSYLVANIA STATE CHAMBER OF COMMERCE,
Harrisburg, April 23, 1954.

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

DEAR SENATOR MILLIKIN: When Clarence D. Laylin, Esq., appeared for the Council of State Chambers of Commerce at your committee's April 23 hearing on H. R. 8300, he orally requested the privilege of having the recommendations of our Federal Taxation Committee incorporated in the record as an appendix to his formal testimony.

Accordingly, we submit a copy of recommended changes in H. R. 8300, and shall appreciate their being recorded as requested by Mr. Laylin. Meanwhile, they are available also to be briefed for members of the Finance Committee.

Sincerely yours,

LEONARD P. FOX,
Executive Director.

Recommended Changes in H. R. 8300, a Bill to Revise the Internal Revenue Laws of the United States

The Federal taxation committee of the Pennsylvania State Chamber of Commerce recommends the adoption of the following proposed amendments to H. R. 8300, a bill to revise the international revenue laws of the United States:

1. DOUBLE TAXATION OF INTERCORPORATE DIVIDENDS

The double taxation of intercorporate dividends should be eliminated. Since 1936, 15 percent of intercorporate dividends have been subjected to the corporate income tax. As a result, corporate income is, to that extent, doubly taxed: first, as earnings in the hands of the distributing corporation; and second, as dividends in the hands of the recipient corporation. Such double taxation is inequitable and contrary to sound economic principles; consequently, dividends should be excluded from the gross income of corporations.

2. PENALTY ON FILING CONSOLIDATED RETURNS

The 2-percent penalty upon the filing of consolidated returns should be repealed. Consolidated returns have been provided for in the tax laws since 1921, as a means of determining the net income of a single enterprise, even though the business is carried on through two or more corporations. No special advantages are derived through the use of such returns. They are recognized and favored by the Treasury Department and taxpayers alike, as the only practical method of determining net income in such cases, and as a method which is fair and easy to administer. The additional rate of 2 percent imposed upon those filing consolidated returns, however, imposes a penalty upon their use which in many cases compels the filing of separate returns. Such a provision clearly discriminates against the business which must be carried on through subsidiaries. Considered either from a viewpoint of equity or administrative convenience, consolidated returns should be fostered by eliminating the 2-percent penalty imposed on their use.

3. NET OPERATING LOSS

Under present law the net operating loss carry-back and carry-forward is subject to certain adjustments not only for the year of the net operating loss but also for the year for which it is carried back or carried forward. Adjustments for those years must be made for tax-exempt interest and dividends received and the excess of percentage depletion over cost depletion. This is a severe injustice. Section 172 of H. R. 8300 partially recognizes the inequities in this situation by eliminating entirely the adjustment for tax-exempt interest and eliminating the other adjustments with respect to the first year to which the net operating loss is carried back or forward. The adjustments for tax-free dividends and percentage depletion should also be eliminated for the year of the loss and all other years. For example, although a corporation earning a profit need include in taxable income only 15 percent of the dividends it receives (by reason of the 85 percent dividends received credit), a corporation sustaining a loss may not, under section 172, carry such loss over to another year unless the loss exceeds 100 percent of its dividend income, thus, in effect, subjecting 100 percent of the dividends to income tax. The dividend has already been taxed in the hands of the subsidiary. It should not again be treated as income for the purpose of reducing a net operating loss since to do so completely negatives the basic purpose of the 85 percent dividends received credit. Similar reasoning applies to the adjustment for percentage depletion.

It is, therefore, recommended that the adjustments for intercorporate dividends and percentage depletion be eliminated from the computation of the net net operating loss deduction for all years including the year of loss by appropriate amendment to section 172.

4. IMPROPER ACCUMULATION OF SURPLUS

1. *Clarification as to proscribed tax avoidance.*—Section 532 (a) imposes the accumulated earnings tax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being divided or distributed." It has long been recognized that the "income tax" referred to in this quoted language is the individual income tax rather than the corporate income tax. This is clearly stated in regulations 118,

section 39.102-1 and has been contained in all preceding regulations dealing with this subject. To avoid a possible different interpretation of this section because of the new statutory language, a clarifying amendment should be made.

It is, therefore, recommended that the word "individual" be inserted before the words "income tax" in the above quoted provision in section 532 (a).

2. *Publicly held corporations.*—Section 532 (b) exempts from the accumulated earnings tax publicly held corporations as defined in subsection (c). Subsection (c) (1) states that a publicly held corporation means a corporation—

"(A) the outstanding stock of which is owned by more than 1,500 persons, and

"(B) not more than 10 percent of either the total combined voting power or the total value of all classes of outstanding stock of which is owned at the close of the taxable year by any one individual."

The above definition obviously does not apply to a subsidiary of a publicly held corporation. Since it is clear that such a subsidiary should not be subjected to the accumulated earnings tax, it is recommended that the rules for determining stock ownership under subparagraphs (A) and (B) quoted above should be in accordance with section 544 which is already made applicable to subparagraph (B) by paragraph (2) of subsection (b).

Recommendation: That paragraph (2) of section 532 (c) be amended by inserting "(A) and" after the term "paragraph (1)."

Furthermore, it is felt the "family rule" for attribution of stock ownership in the case of a personal holding company is unnecessary in this section, because of the requirement that the stock be held by more than 1,500 persons, and should, therefore, be eliminated.

It is, therefore, recommended that paragraph (2) of section 532 (c) be amended by inserting "(A) and" after the term "paragraph (1)," and by inserting "(a) (1)" after section 544.

5. DEDUCTION OF CERTAIN ORGANIZATION EXPENSES

The House Ways and Means Committee have been very generous in the treatment given to organizational expenditures as set forth in section 248 of H. R. 8300. In the committee report referring to this section it is stated in the fourth paragraph that "Expenses of issuing shares of stock, such as commissions, professional fees and printing costs, are a reduction of the proceeds derived from the issue and are properly chargeable against the paid-in capital."

It is not an uncommon practice for corporations to pay stock dividends in the same class of stock. The payment of such stock dividends does not bring in any new capital to the corporation, but the issuance of such a stock dividend does incur expense for professional fees and printing costs. It is recommended that such costs incurred in connection with the issuance of a stock dividend in the same class of stock be included in section 248, and that such expenditures be allowed as a deduction from taxable income.

6. UNION-NEGOTIATED PENSION PLANS

Deductions should be permitted under section 162 (a) of all contributions made by an employer under a union-negotiated pension plan. Such plans are arrived at as a result of collective bargaining between the union and the employer and differ essentially from the types of pension plans contemplated by sections 501 (c) and 403. Such a union-negotiated pension plan constitutes a true business expense, and contributions thereto made by an employer should be allowed as business expenses under section 162 (a) rather than be limited to the restricted provisions of section 403. Such deductions should also be permitted in cases where the plan is voluntarily extended to cover non-union employees as well as union employees.

7. PRICE INDEX FOR MANUFACTURERS USING LIFO

Under existing practice, retailers using the LIFO method of accounting are permitted by the Commissioner to determine the value of their inventories by reference to price indices published by the United States Bureau of Labor Statistics. The use of such indices affords a sound and workable method of determining the value of inventories and at the same time relieves the taxpayer of considerable expense which would otherwise be involved in the determination of such value. It is recommended that the use of such indices be extended to manufacturers employing the LIFO method of accounting, as well as to retailers.

8. COST OF ELIMINATING AIR AND STREAM POLLUTION

In recent years, several States have entered into a program of eliminating the pollution of both air and streams, by the imposition of certain regulatory measures. As a result, many industries have made substantial expenditures in order to comply with these provisions. Taxpayers cooperating with these State programs should be permitted to amortize for tax purposes over a 5-year period the amount of expenditures incurred in eliminating stream and air pollution.

9. LIMITATION OF ASSESSMENT AGAINST TRANSFEREES

The code should be amended to provide explicitly that the additional time for assessment against a transferee shall be limited to cases where the transfer took place prior to the expiration of the statute of limitations against the transferor.

10. CONSOLIDATED RETURNS—ANNUAL ELECTION

Under existing law, an election by an affiliated group of corporations to file a consolidated return is binding upon the group for all future years, with certain limited exceptions. This provision is unnecessarily harsh, and it is recommended that affiliated groups be given an annual election to file either consolidated or separate returns.

11. TAX TREATMENT OF DEMOLITION COSTS

Purchase of real estate with intent to remove and replace old buildings

This situation is not covered either under existing law or H. R. 8300. Under existing Treasury regulations where a taxpayer purchases improved real estate with the intention of demolishing and replacing the improvements, the entire purchase price is considered as the cost of land even though the improvements may have considerable value at the time of purchase. For example, if a taxpayer purchases improved real estate for $2 million and the land and improvements each have a fair market value of $1 million, the taxpayer's investment in land is considered to be $2 million. He gets neither a loss deduction for the demolition of the old improvements nor may he add the $1 million cost of the old improvements to the cost of the new improvements and recover it by way of depreciation over the life of the new improvements. If he has a loss, he recoups it only at the time he disposes of the land.

This constitutes a serious impediment to the rehabilitation of real property. One of the problems facing many large cities today is the rehabilitation of industrial and commercial areas and clearance of slums. Industry has been called upon in many instances to aid in such projects by buying the land, removing the old improvements and installing new and up-to-date industrial facilities. Such projects would be encouraged if taxpayers were permitted to recover by way of depreciation amounts expended for the real estate in excess of the fair market value of the land. Such treatment of these excess expenditures is sound under generally accepted principles of accounting. Under the Treasury's present method of requiring all such costs to be capitalized as part of the cost of land, the taxpayer's books will show inflated land values and thereby mislead the shareholders and public alike as to the true worth of its assets. A rule should be adopted which will not only eliminate these defects but at the same time make it unnecessary to determine the taxpayer's intent in cases of this kind. The latter objective is consistent with the basic principle underlying the entire new tax revision law and should be given effect wherever possible.

It is, therefore, recommended that section 1016 (a) be amended to provide that where a taxpayer purchases improved real estate, the portion of the purchase price allocable to the improvements plus any demolition costs shall be added to the basis of new improvements replacing the old improvements where the new improvements are commenced within 5 years from the date of purchase. To prevent abuse of this rule in cases where the new improvements are insignificant in character, such as where the taxpayer purchases improved real estate and converts it into a parking lot, the rule should be made to apply only where the cost of the new improvements equals or exceeds the purchase price of the land and old improvements.

12. CAPITAL GAINS AND LOSSES

The deduction of capital losses should be allowed on the same basis that capital gains are taxed. Under present law, all capital gains are taxable, regardless of the nature of the transaction from which they arise. Numerous restrictions are contained in subchapter P, however, on the allowance of capital losses. No sound reason presents itself for this difference in treatment, and it is earnestly recommended that the loss be allowed on the same basis that the gain is taxed.

13. CONTRIBUTIONS TO CHARITABLE, EDUCATIONAL ORGANIZATIONS, ETC.

Under present law a corporation is not allowed a deduction for charitable contributions in excess of 5 percent of its net income for the year of the contribution (computed without benefit of the contributions deduction). Frequently, contributions exceed that amount through no fault of the taxpayer. Thus, a corporation may make normal contributions during the first part of the year and have its entire net income wiped out by a strike in the latter part of the year. It never gets a tax benefit from the contributions made under those or similar circumstances. This situation should be corrected by permitting corporations to carry forward such excess contributions to future years. This is permitted in the case of excess contributions to exempt employee trusts. No sound reason exists for not providing the same treatment for contributions to charitable and similar organizations.

It is, therefore, recommended that amounts contributed by corporations to charitable, educational, and other similar organizations in excess of the 5 percent limitation be allowed as a carry forward for succeeding years. This can be accomplished by adding the following provision at the end of section 170 (b) (2): "Any amount paid in any taxable year in excess of the amount deductible in such year under the foregoing limitation shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitation."

14. VALUATION OF LIFO INVENTORIES AT COST OR MARKET

LIFO inventories under present law must be valued at cost. In other words, the inventory at the end of the year may not be written down to market if market value is lower than cost as in the case of inventories computed under the first-in last-out method. Many business and professional organizations, including the various accounting societies, have recommended that the cost or market method of valuation be extended to LIFO inventories.

The LIFO method is designed to prevent fictitious and unrealized paper profits from being reflected in income during periods of rising prices. No one has ever contended that it is sound accounting to reflect such fictitious profits in business income. Since the history of prices over many generations shows a continuously rising trend, it follows that LIFO is the only sound inventory method over a long period of years. Unfortunately, the long term increasing price trend is interrupted from time to time by price declines of a temporary nature so that if a taxpayer elects to go on LIFO immediately preceding one of these periods of price recession, his taxable income is temporarily inflated, thus producing an increase in tax which he can ill-afford to pay in a depressed year. Since prices are relatively high at the present time, new taxpayers are prevented from electing the LIFO method because of the fear of excessive taxation. If it is sound for all taxpayers to be on the LIFO basis over a long period of years, it is sound to encourage taxpayers to adopt LIFO at the earliest date. This can be done only by permitting them to use the lower of cost or market as a guard against an unforeseen precipitous price decline. The government will lose no revenues. Tax is merely postponed until prices rise again to or above LIFO cost, at which time the amount of the previous write-down to market is restored to taxable income and the tax paid thereon.

It is also pertinent to note that permission to write down LIFO inventories to market will be of no aid to taxpayers who elected LIFO many years ago unless prices decline below the level at which they were included in inventory. Since most of these inventories are at World War II price levels, it would take a major depression to benefit these taxpayers. If a depression of such magnitude develops, they will not only need but will be entitled to some relief.

It is recommended that section 472 (b) (2) be amended to read as follows: "Inventory them at cost or market, whichever is lower; and".

15. CONTRIBUTIONS TO CAPITAL

Section 355 (a) of H. R. 8300 provides that with respect to property acquired by a corporation as a contribution to capital, the basis to the corporation shall be the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor upon the transfer. Section 355 (c), however, provides that notwithstanding the provisions of subsection (a), with respect to property acquired as a contribution to capital which is contributed by one other than the shareholder as such, the basis shall be zero; and that with respect to property purchased with money contributed by one other than a shareholder as such, the basis shall be reduced by the amount of the contribution. Thus, the use by the corporation of the transferor's basis with respect to contributed property is made to depend solely on whether or not the contribution was made by a shareholder as such. This rule is without counterpart in existing law and is illogical and harsh in its application.

The use of the transferor's basis by the corporation should turn, not on the transferor's status as a shareholder, but rather on the nature of the transfer itself. Under present law, the corporation is allowed the transferor's basis of contributed property in all cases in which the transfer was made with a definite intention to enlarge the working capital of the corporation. Such a contribution may be made either by a shareholder as such, or by one other than a shareholder in cases where the contribution is made for a public purpose. Examples of this latter type include contributions by community groups to induce businesses to locate in a particular area, or the assumption by the State of a part of the cost of a grade-crossing elimination, although the bridge becomes the property of the railroad for purposes of maintenance, property taxation, and other purposes. These properties become a permanent part of the assets of the corporation, and unless the corporation has a basis for their depreciation, there will be no funds available for the replacement of such properties at the end of their useful life.

On the other hand, the present law does not permit the use of the transferor's basis where the contribution to capital was not made by a shareholder as such, nor for a public purpose, but was made as payment for goods or services or as payments in lieu of income or to supplement income. Examples of this type are powerline extensions or spur tracks, the cost of which is borne by the customers to be served thereby, or subsidy payments made to supplement income.

The present rule has been evolved by the Supreme Court, principally in *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98 (1943), and *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583 (1950), and is now settled law. Furthermore, the American Law Institute in its impartial and comprehensive study of the internal revenue laws has recommended the codification of this rule. It is believed that the rule is both sound and workable and should be embodied in the revision of the Internal Revenue Code.

It is, therefore, recommended that section 355 of H. R. 8300 be amended to provide that with respect to property received as a contribution to capital, including both contributions by shareholders as such and contributions by nonshareholders where made with a public purpose, the basis shall be the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor upon such transfer; and that with respect to property received as contributions to operating facilities, where such contributions are in the nature of payments for goods or services or in lieu of or as supplements to income, the basis shall be zero, and the basis of any property purchased with money so contributed shall be reduced by the amount of such contribution.

16. SECTION 461 (C)—ACCRUAL OF REAL-PROPERTY TAXES

The provisions of section 461 (c) represent a desirable step toward the determination of taxable income in accordance with generally accepted accounting principles. In making the new rule mandatory, however, this section creates a serious problem for taxpayers who have been keeping their books in accordance with existing law. The problem can best be illustrated by an example.

Court decisions have specified the lien date as the proper accrual date for property taxes, but the Internal Revenue Service, for ease of administration, usually uses assessment as the determining event, absent a court decision relating to the specific tax in question. Assume, then, that under present law a tax imposed for the calendar year 1954 has been deemed to accrue on July 1, 1953, its assessment date. Under section 461 (c) (1), this tax would be deductible in 1954. Under the special rules provided in section 461 (c) (2), however, if the tax were allowable, as it is in this example, as a 1953 deduction under the 1939

code, the tax is not allowable as a 1954 deduction. This provision is apparently considered necessary to prevent the deduction of the same tax twice.

The taxpayer in this example is assumed to have been keeping his books in accordance with the present tax rule. To avoid distortion of financial operating results, he will undoubtedly wish to continue to accrue real-property taxes for book purposes on the same basis, as otherwise his operations for the transition year would not include any charge for real-estate taxes. Section 461 (c) (2), however, would not permit a deduction in the transition year for the real-estate taxes which consistent accounting practice would require the taxpayer to accrue.

Section 461 (c) will be very helpful to taxpayers who have been keeping their books by the method contemplated in that section. Clearly, however, taxpayers who have been keeping their books on a basis consistent with present tax law should not be required to make a change. Section 461 (c) should be made elective rather than mandatory.

It is also recommended that section 461 (c) be made to apply to cover personal property taxes.

17. ESTATE TAX—VALUATION OF GROSS ESTATE

Under present law the value of a decedent's gross estate for estate tax purposes may be made either as of the date of death or as of a date 1 year after death. Under section 2032 the alternative valuation date may be used only where the gross estate has declined to two-thirds or less of its value at the date of death. This proposed change in the law introduces severe disparities in tax liability, although the difference in actual value after 1 year may be trifling. Thus, an estate of $1 million in value (gross as well as net) which goes down to $667,000 bears the whole tax of $325,700, while another estate of $1 million which goes down to $666,000 pays only $203,800. A difference in value of $1,000 hardly justifies a difference in tax of $121,900. Corresponding disparities are unavoidable, no matter how large or small the taxable estate, as long as the right to the alternative valuation is made to depend on a minimum change in value. There comes a point where a few dollars more or less of value makes a tax difference many times greater.

The foregoing illustration assumes that there are no debts or administrative expenses. The disparity of treatment and potential hardship become even more severe where there are relatively large amounts of debts and expenses. Thus, a gross estate valued at $300,000 having debts of $200,200 could have its gross value reduced to $200,100, leaving an actual deficit of $100 in net value. Nevertheless, $4,800 in estate tax would be due, although the estate was actually insolvent.

It is, therefore, recommended that the method for valuing the gross estate for estate-tax purposes existing in present law be restored.

18. DEPRECIATION—FULL TAX BENEFIT RULE

Section 1016 (a) (2) of H. R. 8300 provides that the basis of property shall be reduced by the depreciation—

> "(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and
>
> "(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws, but not less than the amount allowable under this subtitle or prior income tax laws."

This provision, like its counterpart in present law, does not permit a full tax benefit from the depreciation allowance. There are two principal situations which prevent a full tax benefit:

1. Where the taxpayer had income in a closed prior year and it is later determined that the amount "allowable" was in fact greater than the amount used in computing income for that year, and
2. Where the amounts "allowable" and "allowed" are the same and result in a deficit in taxable income for the year which the taxpayer was not able to carry back or carry forward either because of lack of income in preceding and succeeding years or because the deficit was reduced or eliminated by percentage depletion deductions, nontaxable interest or intercorporate dividends.

It is, therefore, recommended that section 1016 (a) (2) of H. R. 8300 be amended to provide in substance as follows:

1. That the adjustment to the basis of depreciable property at the beginning of the taxable year be limited to the amount of depreciation "allowed" in prior

years in all cases where the taxpayer's returns for such prior years have been audited by a representative of the Internal Revenue Service. This will protect taxpayers who have had their returns audited against a later determination that the amount of depreciation "allowable" in a prior year was greater than the amount "allowed" for such year. Such a provision will afford ample protection to the Government against any taxpayer who claims abnormally low depreciation in low tax years in expectation of conserving the deduction for high tax years.

2. In any case where the amount of depreciation "allowed" or "allowable" for any prior year exceeds the amount of the income subject to tax for such year computed without benefit of the depreciation allowance, no adjustment to the depreciable base shall be made with respect to any part of such excess which does not reduce the taxable income of another year either as part of a net operating loss carry-back or carry-forward or under other provisions of law.

19. DETERMINATION OF BENEFITS UNDER EXEMPT EMPLOYEES' TRUSTS

In determining benefits payable to employees under an exempt employees' trust, section 501 (e) (4) of H. R. 8300 provides that the compensation to be taken into account is the "basic or regular rate of compensation, or total compensation if amounts other than the basic or regular rate of compensation are determined under a definite formula." The requirement as to a "definite formula" is new and represents what appears to be an unjustified limitation upon total compensation. Many corporations have a policy of paying comparatively low basic compensation and supplementing it at the end of the year with bonuses fixed by management on a merit basis. No sound reason exists for excluding such bonuses from total compensation in determining benefits payable under an exempt employees' trust.

It is understood that the Pension Trust Division of the Internal Revenue Service does not put such a strict construction on the above-quoted provision. Apparently they interpret this language to permit merit bonuses to be taken into account in determining benefits if done pursuant to some formula which would prevent undue discrimination in favor of a high-salaried employee, such as where such employee is given an unusually large bonus immediately before retirement in order to boost his pension benefit. They would merely require that merit bonuses be averaged over a period of 5 years or more in determining compensation upon which benefits are based. This appears to be a sound and equitable approach to the problem but it is difficult to arrive at any such result under the above-quoted provision from section 501 (e) (4). A clarifying amendment should be made.

Recommendation: That the last paragraph of paragraph (4) be amended to read as follows:

"For purposes of this paragraph, the term 'compensation' means the basic or regular rate of compensation, or total compensation, except that compensation paid in addition to the basic or regular rate of compensation during any of the 5 years immediately preceding the date of the employee's retirement (other than additional compensation determined under a definite formula) shall be taken into account for such year only to the extent that it does not exceed the annual average additional compensation for such 5-year period. Any classification which meets the requirements of paragraph (3) of this subsection shall be considered separately in the application of this paragraph."

20. INVENTORIES—SUPPLIES

The internal revenue laws have never defined the items which are properly includible in inventory. This has always been covered by regulation. Prior to 1933 the regulations permitted all materials consumed in the productive process to be inventoried. Under this provision all supplies used in the manufacturing process, including such items as fuel oil, coal for power purposes, etc., could be inventoried at the lower of cost or market. In 1933 the regulations were amended to restrict inventoriable items to materials which become a physical part of the finished product for sale. Thereafter, the Commissioner insisted that supplies could only be inventoried at cost and could not be reduced to market where their market value had declined. The purpose of the change in the regulations was to bolster sagging Federal revenues during the depression years and had no relation to sound accounting principles. The practice which prevailed prior to 1933 should be restored.

Recommendation: (1) That section 471 of H. R. 8300 be amended to specifically include materials and supplies used or consumed in productive or mining processes as items of inventory. To accomplish this, the following sentence should be added at the end of section 471:

"Inventories shall include raw materials and supplies on hand acquired for sale, consumption or use in productive processes (whether or not they will physically become a part of merchandise intended for sale), together with all finished or partly finished goods, except that if the taxpayer carries materials or supplies on hand which will not physically become part of merchandise intended for sale and for which no record of consumption is kept (or of which physical inventories at the beginning or end of the year are not taken), it will be permissible for the taxpaper to deduct from gross income the total cost of such supplies and materials for the taxable year in which purchased provided the taxable income is clearly reflected." (This suggested language is derived from art. 1581 of regulations 45 and sections 39.22 (c)-1 and 39.23 (a)-3 of regulations 118).

Recommendation: (2) Where a taxpayer has consistently inventoried such supplies at the lower of cost or market since prior to 1933, filed a proper election to value such inventories under the last-in first-out method and was denied such election by the Commissioner on the ground that supplies are not items of inventory under the 1933 regulations, section 471 should be amended to permit such taxpayers to value such supplies under the last-in first-out method beginning with the year for which the election was filed and permit adjustments to tax for all years effected whether or not closed by the statute of limitations.

21. DEDUCTION FOR CONTRIBUTIONS TO AN EXEMPT PENSION TRUST

Present law provides certain limitations upon the amount which an employer may contribute to an exempt pension trust. These limitations are carried forward in section 403 (a) (1) of H. R. 8300 with certain changes including an increase in the 5 percent of compensation limitation to 10 percent.

These limitations are still too restrictive in the case of a trust which covers only retired employees or those employees who will retire in a relatively short period of time. This situation exists primarily under pension plans established by union contract. Where the union contract is for 1 year, covers only retired employees and requires the employer to contribute to the trust at least one-fifth of the pension liability created by employees retiring during the year, the contribution will be about twice the maximum contribution permited under section 403 (a) (1).

Recommendation: That section 403 (a) (1) of H. R. 8300 be amended to permit employers to make annual contributions to pension trusts in "An amount necessary to completely fund any unfunded pension liability with respect to employees or their beneficiaries who are receiving or are entitled to receive benefits under the plan as of the end of the taxable year."

22. ACCELERATED PAYMENT OF INCOME TAX

The bill contains new provisions for declarations and advance payment of income taxes by corporations (secs. 6074, 6152, 6154, and 6655). This extension of the deplorable consequence of the Mills bill would amount to a further heavy increase in the taxpayments of corporations with liabilities in excess of $50,000.

It is recommended that these provisions dealing with declarations and advance payment of income taxes be deleted from the bill.

23. DEFINITIONS RELATING TO CORPORATE ORGANIZATIONS, ACQUISITIONS AND SEPARATIONS

Sections 359 (b) (2) and (c) (1) of the bill impose a new restriction upon the tax-free exchange of stock or property of a closely held corporation for stock of an acquiring corporation. Under these subsections, two separate enterprises might continue their businesses in a form different only because of the transfer of stock for stock or stock for property; however, taxable gain would be recognized on the unrealized appreciation in securities or property. This is contrary to the treatment of unrealized appreciation on liquidation under section 331 of the Internal Revenue Code of 1954, and contrary to the provisions of the 1939 code. Where the elements of various exchange transactions are the same, no distinction or discrimination should be made for tax purposes merely because of size.

It is, therefore, recommended that subsections (b) (2) and (c) (1) of section 359 should be deleted from the Internal Revenue Code of 1954.

24. DEPRECIATION SECTION 167

1. Subsection (b) of section 167 permits more flexible depreciation with respect to property acquired after December 31, 1953. This additional flexibility is greatly desired and should be retained in the bill.

Subsection (b) permits depreciation to be computed under: (1) The straight-line method, (2) the declining balance method at twice the straight-line rate, and (3) any other consistent method provided it does not produce an allowance greater than the declining balance method. The limitation in item 3 (subpar. (3) of subsec. (b)) is unduly restricted. For example, application of the declining-balance method at twice the straight-line rate to a 20-year asset leaves an unrecovered cost of about 12 percent at the end of the 20-year period. In some cases this 12 percent will represent the salvage value of the property. In other cases, however, there will be no salvage value and it will be impossible to apply a method under subparagraph (3) which will not run afoul of the limitation. For this reason the limitation should be removed. This will not create any loophole since the Secretary or his delegate can prevent excessive depreciation by appropriate regulations.

Existing law does not specifically list the various methods of depreciation. Some of these methods, such as methods based on degrees of activity, hours of use, units of production, etc., have been recognized by the Internal Revenue Service in the case of some taxpayers and denied in the case of others. The unit of production method is generally recognized in the mining industry but has been denied to some manufacturers on the ground that increased production does not necessarily increase wear and tear of assets used in manufacturing. Since the same argument could be made with respect to mining assets, no sound reason exists for distinguishing between these two situations. The new law should permit all taxpayers to use these methods and at the same time existing law should be clarified by specifically recognizing such methods.

Subsection (b) should also be amended to make it clear that taxpayers are not limited to the use of any single method on all property acquired after December 31, 1953, but may use one method for some assets and other methods for other assets. It should also be made plain that subsection (b) is not intended to limit or reduce the allowance available under existing law now covered by subsection (a).

It is, therefore, recommended that subsection (b) of section 167 be amended to read as follows (new material italicized, omitted material in black brackets):

(b) USE OF CERTAIN METHODS.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any one *or more* of the following methods:

(1) the straight-line method,

(2) the declining-balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1), and

(3) any other consistent method *including, but not limited to, methods based on degrees of activity, hours of use, units of production, or similar factors, or designed to insure full recovery of the basis of property over its estimated useful life. This paragraph shall not be construed as limiting in any way the use of such methods under subsection (a) or under section 23(1) of the Internal Revenue Code of 1939.*

Nothing in this subsection shall be construed to limit or reduce the allowance otherwise allowable under subsection (a).

2. One of the underlying purposes of the new depreciation provisions is to eliminate controversies between taxpayers and the Government as to useful life. The Commissioner's present policy is not to disturb existing rates or methods of depreciation in the absence of clear and convincing evidence that a change should be made. This policy should be codified with respect to rates and methods of depreciation consistently used by the taxpayer for years preceding January 1, 1954, where the Commissioner has had an opportunity to examine the taxpayer's depreciation claim and has made no objection.

It is, therefore, recommended that subsection(d) of section 167 be amended to read as follows (new material italicized, omitted material in black brackets):

(d) AGREEMENT AS TO USEFUL LIFE ON WHICH DEPRECIATION RATE IS BASED.—Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of

this Act, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by registered mail is served by the party to the agreement initiating such change. *At the election of the taxpayer, an agreement under this subsection shall be deemed to exist with respect to any rate or method of depreciation consistently used by the taxpayer for taxable years ending prior to January 1, 1594, provided one or more of such years have been reviewed by the Secretary or his delegate and the latter has not made written objection to the use of such rate or method prior to January 1, 1594.*

3. Subsection (e) provides for the so-called 10 percent rule which permits taxpayers to use the rate claimed on the return unless the rate determined by the Government differs from the taxpayer's rate by more than 10 percent. This rule may produce unfair discrimination. Assume two companies in the same business each use a 4 percent rate which they have used for many years. The revenue agent determines that 3.6 percent is correct with respect to one company and 3.5 percent the correct rate for the other company. The first company will be permitted to continue to use its 4 percent rate, whereas the second company will have its rate reduced to 3.5 percent. Thus one company loses one-half of 1 percent of its rate when the correct rates for the two companies differ by only one-tenth of 1 percent. This should be corrected by providing that the taxpayer's depreciation shall not be reduced below a rate which would qualify under the 10 percent rule if the taxpayer had used such rate in claiming depreciation on his return.

It is, therefore, recommended that subsection (e) of section 167 be amended to read as follows (new material italicized, omitted materal in black brackets):

(e) DISPUTE AS TO USEFUL LIFE AND RATE.—(1) Unless the useful life of any property, on which the rate of depreciation is based, reasonably determined to be appropriate by the Secretary or his delegate, differs from the useful life or rate used by the taxpayer by more than 10 percent, the useful life or rate for such property for such taxable year shall be the useful life or rate as used by the taxpayer. *Such useful life or rate shall not be less favorable than the shortest useful life or maximum rate which would qualify under the preceding sentence if the taxpayer had used such useful life or rate except that the useful life or rate shall not be more favorable than the useful life or rate used by the taxpayer unless a more favorable useful life or rate is otherwise established.*

4. Subsection (h) refers to section 611 for a "special rule" applicable to depreciation of "improvements" in the case of mines, oil and gas wells, other natural deposits and timber. Section 611 (a) merely provides for a "reasonable allowance" for depreciation of such "improvements" according to the peculiar conditions in each case, such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. Under this arrangement mine owners and operators may be denied the benefits of section 167, including the use of a declining balance method at twice the straight-line rate, the written agreement as to rates and methods and the so-called 10 percent rule. This would clearly discriminate against depreciable property used in mining and should be clarified.

It is, therefore, recommended that subsection (h) of section 167 and the words "and for depreciation" in the first sentence of section 611 (a) be deleted.

5. Terminal writeoffs under the declining balance method: Under the declining balance method permitted by the bill, a terminal writeoff of any undepreciated balance is permitted in the year when disposition is made of the last remaining asset of any particular year's acquisition of any class. In order to be able to take advantage of this terminal writeoff, the taxpayer must maintain detailed records of cost and year of acquisition of each asset. Many taxpayers do not maintain, and should not be required to maintain in order to take advantage of the declining balance method, such records with respect to assets of relatively small individual value. In cases where such records are not maintained, however, any particular year's acquisitions must, under the declining balance method, continue to be depreciated, in progressively reducing amounts, ad infinitum. A similar objection can be made to the use of the declining balance method as proposed in the bill in the case of assets for which

detailed records of cost and year of acquisition are maintained, in that, as long as a single asset of any year's acquisition remains in service, it is necessary for the taxpayer to continue recording a constantly reducing depreciation allowance which might eventually be measured in pennies.

The terminal writeoff provision as presently contemplated must be made less restrictive. The problem could be met in any of several ways, two of which are the following:

1. Any remaining undepreciated balance might be written off in the last year of estimated useful life;
2. A minimum depreciation allowance might be provided under the declining balance method equal to a specified percentage (e. g., 3 percent) of the cost of any year's acquisitions of any class, with possibly a limitation that the minimum allowance might in no case exceed the annual straight-line depreciation allowance.

6. Construction begun before and completed after December 31, 1953: Subsection (c) provides that the methods provided in subsection (b), which include the declining balance method, shall apply, in the case of property constructed after December 31, 1953, only to that portion of the basis of the property which is attributable to construction after December 31, 1953. Since depreciation normally starts when a building or other structure is completed and placed into service, it is suggested that, in the case of property construction of which is completed after December 31, 1953, the declining balance method be permitted with respect to the entire cost of the property.

7. Time of election: The committee report (third paragraph, p. A50) might be interpreted to mean that the taxpayer would be permitted to use the declining balance or other acceptable method of computing depreciation only if he computed depreciation under such method for the first taxable year ending after December 31, 1953.

There would seem to be no valid reason why a taxpayer should not be permitted to adopt the declining balance or other acceptable method in any year as long as the method is applied only to assets acquired in such year or subsequent years.

25. SUBCHAPTER G—ACCUMULATION OF SURPLUS

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

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

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

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

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

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

Section 115 (g) (3) was enacted in 1950 to effectuate the purpose of Congress that the impact of death taxes upon owners of closely held family corporations would not result in the forced sale, liquidation or loss of control of such corporations. Congress expressly recognized the inequity and injustice of such corpora-

tions being wrecked by the necessity of payment of estate taxes and also the undesirability to the economy of owners of small businesses being forced to sell out to big business in order to prepare for or pay estate taxes. Accordingly, Congress added section 115 (g) (3) providing in substance that if the interest owned in a corporation constituted a certain percentage of the value of the taxable estate, the stock representing such ownership could be sold to the corporation free from the hazard that the proceeds would be taxed as an ordinary dividend and largely wiped out by such a dividend tax. However, section 115 (g) (3) and now the proposed section 303 of H. R. 8300 do not provide this protection in situations where there is, after the death of the owner, a substitution of stock for the stock owned at the date of death. For example, if a merger, recapitalization or reorganization takes place after the death of the stockholder, the new stock received by the estate in exchange for the stock held at the date of death does not qualify under section 115 (g) (3) or proposed section 303. Accordingly, the estate could not turn in such stock for redemption without grave risk of the proceeds being wiped out by the taxing of them as a dividend. The same undesirable result accrues in the case of an exchange of common for new common in a stock split occurring after death. Similarly, where the decedent held his stock of the operating business in a personal holding company, which was liquidated after his death and the stock of the operating company received by the executors in exchange for the holding company stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(Following is new.)

"(c) SUBSTITUTE STOCK.—A distribution of property by a corporation in redemption of stock received with respect to or in exchange for stock described in paragraph (*a*) and paragraph (*b*) (2) shall be deemed to be a distribution in redemption of and with respect to such stock, if—

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

"(2) the stock so received was received by the shareholder in a distribution in partial or complete liquidation as defined in section 336 of a personal holding company as defined in section 542 and was stock of a corporation of a value—

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

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

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

27. CORPORATE DISTRIBUTIONS—TAX ON TRANSFERS IN REDEMPTION OF NONPARTICIPATING STOCK

The stated purpose of this section is "to eliminate the preferred stock bail out", whereby certain taxpayers have substituted for full income rates capital gain rates on ordinary profit distributions. The purpose of the section is highly commendable.

At least two amendments to H. R. 8300 appear to be indicated, however.

(1) Sections 531 through 536 provide for the surtax on improperly accumulated surpluses. A deduction for any tax paid under section 309 should be provided for in section 535 (b) in the computation of net income taxable under section 531.

(2) The final paragraph (section 309 (c)) provides that the issue date of nonparticipating stock is deemed to be the later of its issue date or January 1, 1954. This provision is entirely arbitrary and will unjustly penalize legitimate redemptions in many cases. Among these are presently operating sinking fund redemptions of nonparticipating stock at call prices in excess of 105, which will continue to operate regardless of the 10-year rule, and the purchase in the open market of noncallable nonparticipating stock issued many years ago for adequate consideration.

It is submitted that as a fundamental proposition the penalty tax should not apply to stock issued for an adequate consideration, for the important reasons why legitimately issued nonconvertible nonparticipating stock are selling substantially in excess of their issue prices are not found in profit distribution motives, but in the financial stability of the issuing corporations and, most important, in the changes in long-term money rates.

As a minimum, the final paragraph providing for the presumptive issue date of January 1, 1954, should be applied only to stock issued for an inadequate or no consideration.

28. SECTION 336 H. R. 8300—DEFINITION OF LIQUIDATION

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

The separate records requirement seems to be a surplusage if the other facts of separateness are established, and also will no doubt frequently constitute a discriminatory trap for small businesses. Large corporations would doubtless have no difficulty in meeting this requirement and would be adequately alerted

by their advisers that the requirement must be met. However, small businesses are not only less likely to keep books of account and records to the precise extent required by this provision, but for obvious reasons are not constantly advised by lawyers and accountants as to refined technicalities of tax law. There is little difficulty in the view that it would be unjust for a small corporation maintaining two clearly separate businesses for the requisite 5-year period to be deprived of the right to a partial liquidation because of unfamiliarity with this provision until the time for liquidation arrived.

It is, therefore, recommended that this provision should be stricken from section 336.

29. SELF-INSURERS AND PROPOSED AMENDMENT OF SECTIONS 1231 AND 165

As a result of the interpretation placed upon section 117 (j) of the 1939 Internal Revenue Code (section 1231 of the proposed 1954 Code H. R. 8300) by the Treasury Department, a segment of the taxpaying public, classified as self-insurers, is being denied ordinary deduction for casualty losses sustained in the operation of hazardous business enterprises. The self-insurers, through no fault of their own, but because of the hazardous nature of their business, are unable to secure insurance. Therefore, they pay no premiums and no deduction is available to them under section 23 (a) of the 1939 code (Sec. 165 of H. R. 8300).

Many of them establish a self-insurance reserve fund to cover casualty losses, crediting the reserve for yearly additions and charging the reserve for losses suffered. Additions to the reserve are charged to operations which procedure conforms to generally accepted accounting principles.

However, as far back as 1925 (Solicitor's Recommendations 2586, IV–I CB 227) this form of addition to the insurance reserve has been denied taxpayers, the Treasury Department holding that there is no authority in the income-tax laws for the allowance as a deduction of an amount set aside as a reserve to cover self-insurance, for the reason that amounts so set aside do not represent ordinary and necessary expenses within the meaning of the statute. Further, it has been pointed out that self-insurer taxpayers obtain any deductions due them, for casualty losses suffered under the provisions of code section 23, subsections (e) and (f), captioned "Losses by Individuals" and "Losses by Corporations" respectively (Sec. 165 of H. R. 8300).

The interpretation placed upon section 117 (j) by the Treasury Department (regulation 118, sec. 39.117 (j)–1: Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business. "* * * Losses upon the destruction in whole or in part, theft or seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there was a conversion of the property into money or other property. * * *") as set forth in paragraph one above, serves to nullify subsections 23 (e) and (f) depriving taxpayers of an ordinary deduction for casualty losses sustained. This result is brought about by the Treasury Department's application, under section 117 (j), of casualty losses (the deductibility of which is provided for under subsections 23 (e) and (f) against long-term gains from the sale or exchange of depreciable assets used in the trade or business. As a result taxpayers may sustain a large property and material damage loss and, if depreciable assets used in the trade or business are disposed of resulting in a long-term gain in a like amount, the entire loss is offset and lost as a deduction. The effect, in spite of the fact that section 117 (j) was added to the code as a relief provision, is that self-insurance taxpayers obtain no deduction for insurance premiums under section 23 (a) and none for casualty losses under section 23.

It is, therefore, recommended that the Internal Revenue Code be amended in such manner that self-insurers will no longer be discriminated against as set forth above. The following suggestions are made:

1. As to section 117 (j) (sec. 1231 of H. R. 8300). Possibly the simplest method is to provide for a direct exception. It is recommended that section 1231 (a) (2) be amended to provide that the provisions thereof shall not apply to taxpayers who qualify as self-insurers.

2. It is also recommended that section 165 of H. R. 8300 be amended by an additional subsection providing that in lieu of any deduction under subsection (a) there shall be allowed at the election of the taxpayer (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to an insurance reserve for casualty losses not compensated for by insurance.

In addition to the above specific recommendations, the following statements of policy are submitted:

1. The corporate income tax rate of 52 percent is too high to be long sustained and should be reduced as soon as fiscal conditions will permit. The Government should work toward a lower budget, balanced at a lower level of spending, so that the reduction of the tax rate to 47 percent provided by the present law will become effective as soon as possible.

2. We reaffirm our previous position relative to the double taxation of corporate dividends. This would allow to the individual stockholder a credit, at the initial personal income-tax rate, for the previous payment by the corporation of a tax upon its net income. H. R. 8300 falls short of our policy but is a most desirable move in that direction.

3. We endorse the bill as a whole and recommend its passage by the Senate. This bill embodies numerous reforms in the structure of our Federal tax laws and it is beneficial to all taxpayers by removing many inequities and administrative and compliance difficulties; it closes many loopholes and thus protects the revenue.

JOHN MCFARLAND,
Chairman, Federal Taxation Committee.

The CHAIRMAN. Congressman Disney, do you have something you want to say to the committee?

Mr. DISNEY. Yes.

The CHAIRMAN. Come forward.

FURTHER STATEMENT OF WESLEY E. DISNEY, ATTORNEY, WASHINGTON, D. C.

Mr. DISNEY. Mr. Chairman, the chief matter I want to discuss very briefly is one on which I have been waiting for a report from the RFC. Hence, my delay for applying for permission to testify.

This involves five banks, and I represent their accountants, Peat, Marwick & Mitchell.

Now, during the bank holiday—and before I go any further I want to leave with the reporter this statement—during the bank holiday of 1933 these banks received aid from the RFC. There are only five of them. Later, in 1938, they began to sink again, and needed more aid, and went back to the RFC. The RFC aided them again, after the Federal Deposit Insurance Corporation became operative. The RFC required that they issue their preferred stock for the new money that they turned in, but also preferred stock for the old money, to be paid out of the earnings of these banks.

Of course, as you know, the corporate rate has gone up since that time, and only about $2 billion has been paid on this old preferred stock.

Congressman Williams of New York, representing the district in which the Utica Bank is located, which is one of the banks in question, introduced a bill that will do the job, and we believe ought to be in this bill. We rather got a brushoff by the Treasury Department, on the general theory that in a tax-revision bill this item had no place.

Notwithstanding that fact, there are three parallel instances that are brought forward in this new bill, such as, for instance, where depositors have accepted preferred stock in the bank and carried it back. Those banks are totally tax-exempt, as long as they are paying these depositors back.

Then, old section 121, shortly after the RFC came into existence, took care of exemptions on dividends. But we want deductions of

the amounts paid for the preferred stock, the old preferred stock. We are not asking that on the new preferred stock issued for this aid in 1938, 1939, and 1940.

The Williams bill is in the exact language in which we think it ought to be.

Now, I must offer this further suggestion: You remember the fight that was here in the Senate a few years ago on the matter of exemption of mutual savings banks which haven't any stock at all. That was made exempt. So, there are three legislative precedents for this proposal that I have, which ought to be in this bill. I needn't remind you experienced Senators the difficulty of putting this through as a special bill. It becomes a target, and all those things, and we might not get a chance to get it through.

Senator LONG. Your main difficulty on a special bill is one man may object, and the Senate is so busy that it never gets taken care of.

Mr. DISNEY. That is correct.

These banks, one of them right now, as a matter of fact, is going through a recapitalization. That is the bank at Syracuse. And it is getting out of this problem. RFC is carrying them for a small quantity of its $9 million indebtedness, and they are getting out of this problem, and getting out on their own. As it is now, they are working for RFC, and the Federal Deposit Insurance Corporation is the watchdog.

Senator LONG. I am not sure I get your point, and I want to get it straight in my mind. Why should we give any more favorable treatment to dividends on old stock than we do to dividends on present stock?

Mr. DISNEY. You shouldn't.

Senator LONG. What type of treatment are you asking for here?

Mr. DISNEY. As against gross income, that deductions for payments made on the old stock, which was worthless at the time they made new mergers—that there be deductions against gross income.

Senator LONG. Will the banks be allowed to deduct what they pay on the old stock?

Mr. DISNEY. Yes, sir.

Let me read you just an excerpt from the bill——

Senator LONG. Someone down the line would pay the tax. The individual would pay tax on that, would he? Or would that be tax-free too? He is getting back the money he invested in his stock. He would get that back too, wouldn't he?

Mr. DISNEY. I am afraid I have confused you here. There is nothing involved here that involves the depositors; not in this instance.

Now, the Williams bill provides that:

> In the case of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States—

and so forth—

> amounts paid by the taxpayer during the taxable year to the United States or any wholly owned agency or instrumentality thereof in retirement of preferred stock issued between January 1, 1938, and December 31, 1940—

and these 5 banks are the only ones to whom that is issued—

> in exchange for preferred stock previously issued by any of the parties to the merger to the United States or any wholly owned agency or instrumentality thereof.

Now, I fussed around in Mr. Stam's office about it for quite a time, and finally he gave me this final message, that he would have no objection. He finally said, "I won't have any objection, but you ought to get a report from the Treasury Department." That is where we got the brushoff.

Senator LONG. They didn't want to take a position at all; is that the idea?

Mr. DISNEY. They just didn't write a report.

Senator LONG. That seems very unjust.

Would you explain to me on what basis this thing is taxed now, and why should it not be taxed? That is what I am trying to get straight in my mind. I am not clear about it at all.

Mr. DISNEY. First, the money RFC first put into these banks, when it went back to aid them again, it was a lost deposit that existed. But notwithstanding that, the RFC in its ordinary course of business required them by contract to issue preferred stock for this old preferred stock. It was a dead asset at the time.

Senator Long. If I have this straight, then, the RFC required the banks to issue preferred stock to whom, now? To depositors or to previous stockholders?

Mr. DISNEY. To RFC. The RFC holds two sets of stock: Preferred stock for the money advanced in 1938–40—whenever the dates were, and an additional preferred stock for the old stock that was advanced during the bank holiday, which was just as dead as a doornail during the time.

Senator LONG. In other words, it was your feeling that the original money that RFC advanced, in the first instance, was money which was invested in the bank at the time the bank was bankrupt, and therefore, that money was gone, but the RFC required these people to issue stock for this money that had been lost?

Mr. DISNEY. And we want a deduction for that old stock, not for the new stock.

Senator LONG. You are paying to the RFC?

Mr. DISNEY. Yes.

Senator LONG. In other words, the Federal Government is getting back the money it lost when it tried to support these banks during the bank holiday?

Mr. DISNEY. That is right.

Senator LONG. You want to get tax relief for giving the Government back the money that was lost at that time?

Mr. DISNEY. We want a deduction from gross income for that stock, and we feel we are entitled to it, under these three legislative precedents that I have set out in this statement. Anybody who will read this statement I believe will be convinced by it.

And I think Mr. Stam will give you the same advice. I am sure he will.

Senator LONG. May I have a copy of your statement, sir?

Mr. DISNEY. Yes.

The CHAIRMAN. We are glad to see you.

Mr. DISNEY. Thank you. I am not quite through.

I want to file a statement here on behalf of some men down in Tulsa, 5 of them, all officers in 3 corporations. Their lawyer reorganized the corporations in the only manner where he could make it a taxable

transaction. And he has since died. I don't mean any reflection on him. He was just not an expert tax man. And it stuck these men for about $400,000 in taxes, in paper profit, not real profit.

So, we want to present that statement. We may have to go another round on it.

The CHAIRMAN. We will put the statement in the record.

Mr. DISNEY. Senator Kerr is interested in it. I have discussed it with him.

Senator LONG. I agree with your theory that if you put it in as a special bill, it will probably sit there forever.

Mr. DISNEY. Yes, it would be a waste of time. It ought to be in this bill, because it brought forward all of these other legislative precedents for it. These three are right in the bill. Thank you very much.

The CHAIRMAN. Mr Stam will give that careful thought.

Thank you.

(The statements submitted by Mr. Disney follow:)

STATEMENT OF WESLEY E. DISNEY IN BEHALF OF AMENDMENT TO H. R. 8300, TO CARRY OUT THE PROVISIONS OF H. R. 7488

My name is Wesley E. Disney. I am a lawyer with offices at 501 World Center Building, Washington, D. C., and at Tulsa, Okla. I appear for Peat, Marwick & Mitchell, accountants, representing certain banks, namely:

Commonwealth Trust Co., Union City, N. J.
First Bank & Trust Co., Utica, N. Y.
First Trust & Deposit Co., Syracuse, N. Y., the Trust Co. of New Jersey, Jersey City, N. J., and West Hudson National Bank, Harrison, N. J.

During the bank holiday of 1933 the RFC went to the aid of some hundreds of banks, which issued their preferred stock for cash advanced them by the RFC. As time went on these banks got into better shape. With reference to a very few of those banks, including those that are interested in the amendment hereinafter discussed, and which banks continued in a weakened condition, and after the FDIC became operative, it became necessary for the RFC to again go to the aid of these banks with additional funds during the period 1938–40.

RFC required that the banks, some of which were merged with failing banks, issue to the RFC preferred stock for its old money (the bank holiday money theretofore advanced), as well as the new 1938–40 money advanced by RFC, and required that these banks pay out of their earnings amounts sufficient to retire both types of preferred stock. In the last 13 years these banks have been able to retire a little more than $2 million of the RFC stock. No common-stock dividends have been paid to the stockholders of the banks; consequently, reorganization of the banks and the procuring of new private capital has been substantially impossible.

Congressman Williams of New York has introduced H. R. 7488, which provides for a deduction from the gross income of the banks, of the amount paid in retirement of the RFC "old" stock—that is, the stock which represents the amount of money the RFC had already lost in these banks prior to the time it went to the aid of these banks in 1938 and 1940. That was the bank holiday money advanced. We do not ask for the right to deduct from gross income the amount of money paid in retirement of the new (the 1938–40) money advanced by the RFC, and for which RFC now holds the preferred stock of the banks.

This presents no new or novel idea. This bill H. R. 8300 contains a provision which is labeled section 583 and is now the law under section 121 of the Internal Revenue Code. This section 583 was passed by the Congress under the act of 1934. It was designed in aid of the mutual savings banks, which have no stock.

Again the question arose in 1938 when Congress recognized the hardship that had been imposed on certain banks and their depositors. These were banks which were permitted to reopen on a restricted basis and went through reorganization whereby the depositors agreed to take preferred stock in lieu of specified percentages of the deposits in their banks, and the banks worked out for themselves a sound financial structure. As I said, Congress recognized the hard-

ship and enacted an amendment to section 22 of the act of March 1, 1879, by means of section 818 of the Revenue Act of 1938. This amendment of 1938 exempted those banks from Federal income taxes so long as their net earnings were required for the retirement of the preferrd stock for the satisfaction of depositors' claims against the banks. This act of 1938 is now in the Internal Revenue Code as section 3798, and except for a minor amendment made in 1939 remains in the code, and is in H. R. 8300 as section 7507.

Now in view of these legislative precedents which I have cited it seems to me that we are by precedent and in equity entitled to the amendment introduced by Congressman Williams, obviously for the aid of the Utica, N. Y., bank.

The "old" RFC stock (I mean by that the preferred stock issued prior to 1938–40), due to economic events which occurred prior to the 1938–40 arrangement, had lost all value. These excess payments in reality represent payments of losses previously sustained by the RFC. We think that in all equity these institutions should be allowed to deduct such payments from their gross income for Federal tax purposes. If the banks are allowed this deduction they can and will secure new money sufficient to pay off the RFC, reorganize their banks and be on a sound financial basis.

What we ask is an amendment whereby we may have a deduction from gross income of the amount paid in retirement of the RFC "old" stock. I mean by that, the bank holiday money advanced. We do not ask for the right to deduct from gross income the amount of money paid in retirement of the new, the 1938–40 money advanced by RFC.

Congress had something like this in mind in 1934 when it enacted section 121 of the Internal Revenue Code, which is section 583 of H. R. 8300 and which reads as follows:

"*In computing the net income* of any national banking association, or any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of *any other banking corporation* engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a *deduction from gross income, in addition to deductions* otherwise provided for in this chapter, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The *amount allowable as a deduction* under this section shall be deducted from the basic surtax credit otherwise computed under section 27 (b)." [Italics ours.]

This establishes to use that the Government did not and does not expect financial institutions to pay their earnings to the United States Government or instrumentalities thereof without receiving tax benefits on the payment thereof.

This "old" RFC stock, due to economic events which occurred prior to the 1938–40 arrangement, had lost all value. These excess payments in reality represent payments of losses previously sustained by the RFC. We think that in all equity these institutions should be allowed to deduct such payments from their gross income for Federal tax purposes. If we are allowed this deduction we can and will secure new money sufficient to pay off the RFC.

In spite of the inflationary situation in recent years, which increased deposits, these banks, working with the banking authorities, have been able to keep the proper proportion of capital assets to deposits in such shape that the banks have remained in a sound condition.

You may suggest that it would seem unfair that those banks which were reorganized under the bank holiday be required to pay off the money advanced by RFC, and to allow those banks which underwent a second reorganization or merger in 1938 to 1940 to avoid the payment of the first advance by a deduction. However, you should keep in mind that when the second reorganization took place in a very few banks the first advance by the RFC was a total loss.

A number of the banks which were permitted to reopen on a restricted basis went through reorganizations whereby the depositors agreed to take preferred stock in lieu of specified percentages of their deposits in their banks, and the banks worked out for themselves a sound financial structure. In 1938 Congress recognized the hardship which had been imposed on these banks (and their depositors) and granted a measure of relief by amending section 22 of the act of March 1, 1879, by means of section 818 of the Revenue Act of 1938. This amendment of 1938 exempted those banks from Federal income taxes so long as their net earnings were required for the retirement of the preferred stock for the

satisfaction of depositors' claims against the banks. This act of 1938 is now incorporated in the Internal Revenue Code as section 3798 and except for a minor amendment made in 1939 remains in the code.

Since FDIC was created it has gone to the aid of over 200 banks and had used 4 means of providing protection. Briefly stated, they are—

(1) Permit the regulatory authorities to liquidate the weak banks and discharge its insurance liability to the depositors.

(2) Liquidate the weak banks through its own staff and discharge its insurance liability to the depositors.

(3) Transfer the acceptable assets and the liabilities of the weak banks to sound going banks by sale, and discharge its insurance liability by paying to the going banks an amount necessary to make the acceptable assets equal to the liabilities of the weak banks, retaining the unacceptable assets of the weak banks for liquidation.

(4) Arrange a merger of two or more weak banking institutions, advance funds to make the acceptable assets of the merged institutions equal to the liabilities, and take over the unacceptable assets through "loan" or "purchase" as security for the advances.

As I have stated, some weak banks which FDIC was required to assist had previously received funds from the RFC for debentures or preferred stock. In those situations where the FDIC elected to follow plans 1, 2, or 3 above, the RFC lost its investment, except where the liquidation of the unacceptable assets by FDIC resulted in the accumulation of funds in excess of those required to repay the FDIC's advance.

In substantially all of the banks assisted by FDIC under plan No. 4, the merger method, the RFC had advanced funds for either debentures or preferred stock. At the merger dates all of the advances were represented by preferred stock. These are the institutions for which we ask relief. All of these plan 4 mergers were consummated between January 1, 1938, and December 31, 1940. In each case the banks involved in the mergers were deemed to have deposits and other liabilities in excess of assets acceptable to the supervisory authorities. FDIC met its insurance liability by advancing to the continuing institution cash exactly equal to the excess of deposits and other liabilities over acceptable assets. In no case was there any equity remaining in the continuing bank, either for preferred or common stockholders, at the merger dates. You must keep in mind that the RFC had voting control of all the banks involved in the mergers and the individual stockholders were not permitted to raise new capital for the operation of the continuing banks. The newly issued RFC preferred stock was of no value at the merger dates.

The agreements provided for a sinking fund to be established from future earnings of the bank for the retirement of the RFC preferred stock.

These plan 4 mergers required a total amount of retirement value to be paid to the RFC by the banks of $52,387,073.50. This total was made up of shares representing (1) unpaid accrued dividends amounting to $2,378,961.63, (2) shares representing the prior worthless investments of the RFC amounting to $28,194,038.37, and (3) shares representing the cash advanced by the RFC at the time of the mergers in the amount of $21,814,073.50.

In the agreements provision was made for the payment of annual dividends at progressively increasing rates (eventually amounting to 4½ percent), and in every case these annual dividends have been paid currently.

As of December 31, 1952, the total retirement amount still due to the RFC under the plan 4 mergers was $38,540,350.

In addition to assisting commercial banks and insurance companies by the provision of capital funds, RFC provided funds for several savings banks through the purchase of debentures therefrom. This aid by RFC to the savings banks was because losses and shrinkage in asset values had seriously weakened the financial structures of such institutions (the case of the commercial banks). Since the losses which weakened the financial structures of the savings banks were sustained in years when the savings banks were not subject to tax (and, therefore, created no tax benefit) it was felt that taxing income which must be used to reimburse the RFC would be onerous to the savings banks and highly inequitable. As a result of this feeling, Congress enacted section 313 (g) of the Revenue Act of 1951 and added section 23 (dd) to the code, which now is section 592 of H. R. 8300, which section reads as follows:

"In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit,

amounts paid by the taxpayer during the taxable year in repayment of loans made prior to September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States or (2) any mutual fund established under the authority of the laws of any State."

The commercial banks involved in plan 4 mergers were subject to Federal income taxes, but it is true that the losses which brought about the entire disposition of the funds advanced by the RFC prior to the 1938-40 mergers, as well as all of the funds advanced by the common stockholders, resulted in no tax benefit to the banks. First, the losses sustained exceeded the banks' taxable income. Second, although commercial banks were subject to Federal income tax, exemptions granted to certain classes of income, received mainly by banks and other financial institutions, created a situation where a very few commercial banks were liable for any Federal income tax, even without the deduction of the extraordinary losses which occurred in the 1930's.

The affected institutions have only been able to reduce the guaranteed obligations required of them by the RFC from $28,194,000 to $25,523,000, in a period of substantially 14 years. At this rate, conceding for the purpose of argument that conditions will remain as is, it will be a long period of time before these banks pay their RFC obligations. Many years will elapse before the present $25 million plus can be liquidated. In other words, the banks will be run for that long period of time for the benefit of the RFC instead of their owners, the common stockholders. This creates a situation as onerous and inequitable as that recognized by Congress in the enactment of section 313 (g) of the act of 1951 and section 818 of the Revenue Act of 1938.

Laying aside all other considerations, it may be suggested that in the event of another recession these banks could easily become the target of drains on them that would ruin their otherwise sound basis.

As I have heretofore stated, with the passage of the amendment which I have heretofore furnished you, these banks feel certain that they can effect a private reorganization, procure new money and get themselves into shape as going business concerns. In fact, one of the banks is already working on such an arrangement, hoping that the legislation will pass and that they will be able to put themselves in shape to operate as business concerns, believing that the passage of the legislation herein set forth is sufficiently parallel to their present needs to justify this expectation.

A report on this Williams bill 7488 has been requested of the RFC by Chairman Reed of the Ways and Means Committee. That report should certainly be favorable. We have cleared the matter with Counsel Stam of the joint committee, who after extensive study said he would offer no objection to the amendment, but hoped a report would come from RFC.

[H. R. 7488, 83d Cong.]

A BILL To amend section 23 of the Internal Revenue Code relating to deductions for retirement by banks of certain preferred stocks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, (a) section 23 (relating to deductions from gross income) is hereby amended by adding at the end thereof the following:

"(gg) RETIREMENT BY BANKS OF CERTAIN PREFERRED STOCK.—In the case of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone which was a party to a merger between January 1, 1938, and December 31, 1940, in accordance with arrangements made with the Federal Deposit Insurance Corporation, amounts paid by the taxpayer during the taxable year to the United States or any wholly owned agency or instrumentality thereof in retirement of preferred stock issued between January 1, 1938, and December 31, 1940, in exchange for preferred stock previously issued by any of the parties to the merger to the United States or any wholly owned agency or instrumentality thereof. Any bonds, notes, stocks, or other securities issued on or after January 1, 1941, to the United States or any wholly owned agency or instrumentality thereof shall be deemed, for the purpose of this paragraph, to be preferred stock issued between January 1, 1938, and December 31, 1940, if issued (including issuance by the same or another corporation) to refund or replace preferred stock issued between January 1, 1938, and December 31, 1940, but only to the extent that the retirement value of the new securities does not exceed the retirement value of the preferred stock issued between January

1, 1938, and December 31, 1940, which such new securities are issued to refund or replace. For the purpose of this paragraph the issuance of such new securities to refund or replace preferred stock shall not be regarded as payment of such preferred stock. The determination of whether securities were issued to refund or replace preferred stock issued between January 1, 1938, and December 31, 1940, shall be made under regulations prescribed by the Commissioner with the approval of the Secretary."

SECTION 353

Under date of September 21, 1942, a contract was entered into between the Standard Bond & Investment Co., its two 100 percent owned subsidiaries, Standard Paving Co. of Oklahoma and Standard Roofing & Material Co. and its stockholders, I. V. Gray, J. B. Gray, H. C. Gray, Chas. Gray and J. L. Gray, which provided for:

1. The transfer of all of the net assets of the Standard Paving Co. of Oklahoma to Standard Bond & Investment Co. in complete liquidation of its capital stock, and also for its dissolution.

2. The transfer of all of the stock of Standard Roofing & Material Co. to the stockholders of Standard Bond & Investment Co., pro rata, in exchange for the exact number of shares of Standard Bond & Investment Co. stock originally issued to them for the Standard Roofing & Material Co. stock.

3. Changing the name of Standard Bond & Investment Co. to Standard Paving Co. (name changed September 21, 1942—Standard Paving Co., dissolved by court order November 12, 1942).

4. Reduction of Standard Bond & Investment Co. authorized capital stock to 2,500 shares of no par common.

5. Reduction of Standard Roofing & Material Co. authorized capital stock to 2,500 shares of no par common.

For further details see copy of contract enclosed.

The transfer of the net assets of Standard Paving Co. to Standard Bond & Investment Co. would be a statutory merger under code section 112 (g) (1) A, and therefore would be classed as a nontaxable reorganization. (See *Pinellas Ice and Cold Storage Company* v. *Commissioner* (57 F. 2d 188, aff'd 287 U. S. 257); *Cortland Specialty Company* v. *Commissioner* (60 F. 2d 937, cert. denied 288 U. S. 599); *LeTulle* v. *Schofield* (308 U. S. 415).)

The scaling down of authorized capital stock of Standard Bond & Investment Co. to 2,500 shares and Standard Roofing & Material Co. to 2,500 shares would come under section 112 (g) (1) E, and would be nontaxable. (See also Cook on Corporations, vol. 5, sec. 883.)

The Standard Bond & Investment Co. had no surplus or accumulated earnings on the date of the contract. Shares in the Standard Bond & Investment Co. were owned by the Gray brothers in the following proportions:

I. V. Gray	43,906	J. B. Gray	10,707
Charles Gray	17,328	H. C. Gray	13,235
J. L. Gray	14,824		

These companies engaged in an entirely different type of business and really had no connection with each other except for common stock ownership. It was therefore desirable for business reasons to separate the operation of the Standard Paving Co. from that of the Standard Roofing & Material Co. The Standard Paving Co. had little or no surplus or accumulated earnings on January 1, 1942. The Standard Roofing Co. had little or no surplus or accumulated earnings on January 1, 1942. There was no apparent tax advantage to any of the companies or their shareholders to enter into the plan of reorganization. The Standard Paving Co. was engaged in war contracts and kept its books of accounts on the completed contract basis. The major contracts were not completed on September 21, 1942.

The newly organized Standard Paving Co. of Delaware had a loss on contracts which were acquired subsequent to September 21, 1942.

If the income of the companies had been reported on a completed contract basis the gain from the contracts entered into by the Standard Paving Co. of Oklahoma before the reorganization would have been offset by the losses incurred on contracts entered into after the reorganization. This result, of course, was not foreseeable or contemplated by the parties at the time of the reorganization.

From a tax standpoint the Standard Bond & Share Co. could have distributed to its shareholders both the stock of the Standard Paving Co. of Oklahoma and

the stock of the Standard Roofing & Material Co. without entering into the reorganization and without tax liability for the reason that it had no accumulated earnings or surplus. Tax advantage, therefore, did not materially enter into the plan of reorganization. It should be pointed out that after the reorganization both the Standard Paving Co. and the Standard Roofing Co. continued to operate as active corporations and that both are still so operating. The question of an inactive corporation does not enter into the picture.

The Government is now taking the position that because the stock of the Standard Roofing & Material Co. was not first transferred to a new corporation for its stock and then the stock of the new corporation distributed to the taxpayers that the distribution constituted a taxable dividend because the Standard Roofing & Material Co. was not a party to the reorganization.

They first changed the method of accounting used by the Standard Paving Co. of Oklahoma by closing the contracts at the date of the reorganization.

The facts relating to the creation of a surplus in the hands of the Standard Paving Co. of Oklahoma as of the date of the reorganization are fully related in the case of *Standard Paving Company* v. *Commissioner* (13 T. C. 425, affirmed, 190 F. 2d 330).

The Government then stretches the rule promulgated in the case of *Sansome* v. *Commissioner* (60 F. 2d 931), and is holding that the Standard Bond & Share Co. inherited the surplus of the Standard Paving Co. of Oklahoma on the reorganization and thus that the Standard Bond & Savings Co. had a surplus on the date of the reorganization which it distributed in the form of the stock of the Standard Roofing & Material Co. as a part of the reorganization. Thus by the use of three off-brand accounting theories they create a tax liability in a transaction whereby the stockholders stood in exactly the same shoes after the reorganization as they did before, did not receive one dime of profit and ended up with a $400,000 additional tax liability because of the paper transaction, none of which was entered into for tax purposes.

It is my belief that the purpose in enacting section 353 of the code is to permit divisive reorganizations such as split-offs, spin-offs, and other distribution of a corporation's assets on an equal basis without requiring expensive plans or reorganizations requiring the services of the most astute legal advisers.

The Government admits in this case that if a new corporation had been organized as a part of the plan or reorganization, and the stock of Standard Roofing & Material Co. had been first transferred to that new corporation distributed to the stockholders of the Standard Bond & Share Co. instead of directly distributing the stock of the Standard Roofing & Material Co. to the stockholders as was done, that the transaction would have been nontaxable. It is our belief that if relief in situations such as this is to be granted in the future, such relief should be applied retroactively because the same reasons exist for relief in the past as exist for relief in the future.

The whole general purpose of subchapter "C", section 301 through section 359, seems to be to relieve the unwary from tax traps which have resulted from the hypertechnical application of courtmade law applied in various ways to corporation acquisitions and distributions. The general purpose of the new code seems to be to encourage such acquisitions and distributions rather than to create tax traps thereby.

This particular transaction could have been accomplished tax free in several ways if the now deceased legal adviser of the taxpayer had been thoroughly skilled in the application of the complicated reorganization provisions of the Internal Revenue Code and the decisions rendered thereunder.

It is our belief that the taxpayer should not be taxed out of existence because of the lack of skill of its legal advisers and that section 353 of the code should be made retroactive in order to relieve the inequitable consequences which may result in this case.

H. R. 8300 is changing this inequitable situation simply because it is inequitable. The same reason exists for making this provision retroactive as exists for its passage. These taxpayers received no actual profit. They are in exactly the same position as before the recapitalization.

If relief is to be afforded for future transactions it should be afforded to those on which the statute of limitations has not closed the door. Since the statute has not run, it appears to us that the parties are entitled to the benefit of this legislation.

The CHAIRMAN. Mr. Coates.

STATEMENT OF CHARLES F. COATES, C. P. A., CONNECTICUT DEVELOPMENT COMMISSION, HARTFORD, CONN.

Mr. COATES. Mr. Chairman, members of the committee, my name is Charles F. Coates; I appear here as vice chairman of the Connecticut Development Commission and chairman of the New England Regional Committee on Industrial Development Problems.

I had the privilege of appearing before the House Ways and Means Committee on July 23d of last year. At that time I urged that the new tax bill should include an amendment to section 23 (A) (1) (a) of the Internal Revenue Code, to more adequately cover the operations of the nonprofit industrial development corporations that qualify under section 101 (8) of the code, and whose sole purpose is that of promoting employment in areas that have suffered from economic regression or are otherwise aiding in the transition from declining industries to growth industries.

At the present time the Treasury Department does not, or is not able, to render a ruling on such operations that comes to grips with the real problem of the nonprofit industrial development corporation.

For example, in my own State of Connecticut we have such an industrial corporation, known as the Tri-County Development Corp., that was set up at the suggestion of the State Development Commission to promote employment in an area that suffered from the exodus of plants in the textile industry. The Tri-County Development Corp. wants to build new plants to lease to manufacturers able to bring new jobs into the area.

Moreover, it has been our experience that an agency such as Tri-County, which does not have any funds of its own, can obtain the funds necessary from credit grantors and investment corporations to build plant properties only if it is in a position to repay its obligations within 5 years. It is for that reason that such a corporation should be in a position to charge sufficient rental to pay off its obligations within the 5-year period regardless of the length of the lease period with nominal rentals thereafter, and by the same token, it is only logical that the Federal Government permit through the amendment of section 23 (A) (1) (a) that the lessee can take a tax deduction for the full amount of such rentals in the year incurred or paid.

Inasmuch as the lessor corporation holds title and will continue to hold title to such property, such a plan has the effect of providing an incentive to industry to locate in the area.

I believe that the suggested amendment might be somewhat along the following lines:

This is an amendment to section 23 (A) (1) (a).

> In the case of development corporations organized as tax-exempt corporations qualifying under the provisions of section 101 (8) to hold real estate for the purpose of reviving areas suffering from economic regression or otherwise aiding in the transition from declining industries to growth industries, rentals required of lessee corporations for the continued use and possession of land and buildings in sufficient annual amounts to retire obligations of such lessor development corporations based on a period of 60 months, with subsequent annual rentals in reduced amounts.

Through such a procedure the lessee's tax money—money that would otherwise be paid in taxes—is used to retire the cost of the property and he has the further advantage in that the net rental after the fifth year is just a nominal rental.

On the other hand, the Federal Government is in reality only deferring receipt of tax revenue because it will be collecting a higher tax after the fifth year when a smaller or nominal amount is chargeable as rent. At the present time the Treasury Department takes a contrary view in its rulings on such projects.

Specifically, it has ruled under the present construction of section 23 (A) (1) (a) that such a procedure of paying high rentals in the early years constitutes a prepayment of rentals applicable to the later years, thereby disallowing to the lessee the right of a tax deduction for the prepayment portion and requiring that such assumed prepayment be spread over the full term of the lease.

You will realize they allow the deduction ultimately but it must be spread through the lease on a determined proportion of what is the prepayment, which of course is subject to a great deal of controversy.

We must all recognize that there have been basic underlying trends which have influenced the course of financing industrial buildings in recent years. Most of these have their origin in a desire on the part of manufacturers to utilize their available resources in production rather than in bricks and mortar.

The growing use of the lease-back arrangement and the spread of the use of industrial revenue bonds are two of the most significant devices that have resulted from this desire of manufacturers. It is patent that the right to use property is desirable, without ownership thereof, since manufacturing concerns are primarily in the business of making profits from manufacturing operations irrespective of property ownership.

And not from the ownership of real estate.

It has been our experience that the first can be utilized by only a relatively small percentage of manufacturers because the credit grantors predicate any favorable action on a high credit rating. Until the development of the use of the industrial revenue bond in Mississippi, some manufacturers were occasionally induced to enter into agreements with local groups that had raised funds by popular subscription for the express purposes of luring industrial jobs into their communities. The majority of such projects were relatively small in dollar amount because of the limitations of local subscription methods.

The State-sponsored industrial revenue bond, on the other hand, opened up the possibility of obtaining large sums of money and at the same time provided a very pointed challenge to those areas not willing to adopt such legislation.

I do not presume to attempt to solve the constitutional questions involved in this industrial revenue legislation. We are aware, however, that there has been a division of opinion between the governing bodies of the several States on the legality of placing the full faith and credit behind the bonds. Some States do so, while others make the bonds stand on their own.

I think that it is worth considering also that if section 274 were to stand in the new tax bill, it could very well result in a race between the States to place legislation on the books, placing full public faith and credit behind all industrial revenue bonds.

My proposal would have the prime advantage of avoiding constitutional conflict. We are anxious to put this matter of industrial financing on a positive basis that will help all areas impartially. What we

really need is something that will implement the efforts of those endeavoring to hold industry in the older industrial areas of the Nation but which is sufficiently adaptable to enable communities who are endeavoring to build new industrial areas to utilize the advantages of the amendment.

I wish to further emphasize the fact that my proposal not alone avoids constitutional conflict, but at the same time, has the highly important advantage of wide geographical acceptance.

Although reports indicating acceptance of the proposal are coming in each day, already we have on the record favorable acknowledgment from many distinguished citizens in various sections of the nation.

For example, Walter Raleigh, executive vice president of the New England Council; Richard Preston, commissioner of the Massachusetts Department of Commerce and secretary-treasurer of the New England Regional Committee on Industrial and Development Problems; Clifton R. Miskelly, managing director of the Vermount Development Commission; Raymond V. Long, director of the Virginia Department of Conservation and Development; John W. Watt, Jr., executive director of the Oregon Development Commission; Hugo A. Carlson, executive secretary of the South Dakota Natural Resources Commission; Jack V. Boyd, executive director of the Oklahoma Planning and Resources Board; Don C. Weeks, director of the Michigan Department of Economic Development.

These represent a random geographical cross-section of those coming to the support of my proposal. I am confident that you will find growing support for this in the ensuing weeks.

I thank you.

Senator LONG. Let me ask you this question.

Does this mean some loss of revenue to the Government by adopting your proposal?

Mr. COATES. The Tri-County Development Corporation was organized 3 years ago with an understanding from the Treasury Department that we could do the very thing that I am now proposing. And, after we had some prospects lined up and came to the Treasury Department for a fixed ruling, they then ruled that what you are doing is paying advance rent and therefore, you must spread that rent through the lease.

We had lease arrangements on a 50-year basis.

Senator LONG. As a southerner, I am in favor of doing anything within reason that can be done to help you with your problems up in New England.

Mr. COATES. You see, Tri-County being a tax exempt organization, there is no loss in taxes. As far as the corporation is concerned, they would apply the high rental during the first 5 years which would be equal to the cost, so the loans of Tri-County would be paid back to the loaning institutions, whether insurance companies, or banks, or what not——

Senator LONG. Here is the sort of question that occurs to me: I am in favor of doing anything we can to help these distressed areas of the country. I don't think you ought to try to help one area without helping somebody else. I think we ought to go together in this country and provide more jobs and get these 4 million people back to work.

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Nevertheless, I can't help but notice over on the House side, they insisted upon putting in a provision that many people in the South regard as being just punitive against some Southern States.

Mr. COATES. The denial right?

Senator LONG. Wanting to impose additional tax liabilities on those who take advantage of some of these plans in some Southern States to try to develop new industry.

Mr. COATES. I am inclined to feel that might not hold up, constitutionally.

Senator LONG. What is your view on that? Do you approve of this thing by trying, by the taxing power of this Federal Government, trying to prevent those Southern States from doing what they can to overcome their economic problems?

Mr. COATES. This administration has stated that it is out to help industry, and it is out to help industry in the feeling that if industry is helped, more jobs will be created and perhaps there will be less of the giveaway program necessary.

I think whatever legislation is placed upon the books to help industry, should be available to all of the States, without any limit, without any reservation.

Senator LONG. Here is a point I have in mind: Now you want an amendment in this bill, and offhand I see nothing wrong with it, to give some relief to a nonprofit corporation that seeks to develop a distressed area.

Mr. COATES. That is right.

Senator LONG. And that certainly has merit on the face of it, and yet, at the same time, I must notice that some representatives from your section of the country have seemed to feel that it was a burden upon them to place taxation in this bill upon devices being used in some Southern States to try to help overcome their economic distress.

Are you in sympathy with that type of undertaking?

Mr. COATES. I think some of these Southern States, they issue these industrial bonds that are tax exempt, and some of the other States are not willing to issue that kind, particularly when the full credit of the State is involved, because they don't think that money collected as taxes should be used to develop industry.

Senator LONG. They are doing more than that. In some instances they are agreeing they won't collect ad valorem taxes for 10 years from new corporations that come into the States. That is not because they don't want those corporations to pay taxes. They would rather do that than pay a 3-percent sales tax themselves to educate their children. But they realize the great need in that area to have industries just like you have them in your part of the country.

Now all I have in mind is: Do you approve of this thing of trying to put revisions in these tax laws to try to prevent various States from trying to develop their States industrially?

Mr. COATES. I think whatever revision is written into the tax law should be written in such a way to help industry and should help all States without question.

It shouldn't involve some of these other constitutional questions that we have been talking about for a long, long time.

Senator LONG. You wouldn't approve of a tax bill that helps some and punishes others, would you?

Mr. COATES. No. I feel this way. You give me the same opportunities as the other fellow, and I will fight my way out.

The CHAIRMAN. Thank you very much.

Mr. Chapman, please sit down and be comfortable and identify yourself to the reporter.

STATEMENT OF ALGER B. CHAPMAN, EMPIRE STATE CHAMBER OF COMMERCE, ALBANY, N. Y.

Mr. CHAPMAN. Mr. Chairman and members of the Finance Committee, I am Alger Chapman, an attorney from New York, and I appear here on behalf of the Empire State Chamber of Commerce, with headquarters in Albany, N. Y.

I wish to make a brief general statement, and to ask your permission to file with the committee, for inclusion in the record, a technical memorandum which quite frankly is still being worked on, and probably will be finished—certainly be finished before Monday.

The CHAIRMAN. Mrs. Springer, when do we expect to close the record? You beter move along with that. We expect to get this closed this weeek.

Mr. CHAPMAN. We will file it even though not completed, rather than have it omitted.

The principal reason for my appearing this morning is to emphasize as strongly as I can on behalf of the Empire chamber that enactment of the bill will represent a highly commendable and much-needed reform of the internal-revenue laws.

The testimony for the last 2 weeks shows that, with few exceptions, witnesses have praised the bill as a whole. Nevertheless, the committee has heard testimony suggesting that the bill is lengthy, complex, too much to be digested at once, and that perhaps major portions thereof should be deferred, pending further study. It seems clear to the Empire State chamber that it would be a grave mistake to adopt any such piecemeal procedure, because, first, a good, workmanlike job of drafting has been done; second, the major drafting and policy weaknesses have already been discovered; third, there is sufficient time to correct them; and fourth, a great deal would be lost if the present opportunity to make the proposed reform a reality were passed by.

It would be a grave mistake, in the estimation of the chamber, to lose this opportunity to put through this overall proposed reform.

For example, much of the criticism has been leveled at subchapter C of chapter 1, relating to corporate distributions and adjustments. This portion of the bill is of necessity the most complicated. Consequently, it is not so quickly understood and is more susceptible to technical errors in preparation. The criticism should, therefore, come as no surprise.

I am familiar, however, with some of the various discussions which have been and are now going on with the joint committee and Treasury staffs, and I am satisfied that substantially all this criticism can and will be satisfactorily handled.

For example, so far as subchapter C of chapter 1 is concerned, the elimination of the 25–400 percent requirement in respect of corporate acquisitions, which I believe is now contemplated, will meet one of the major and most justified complaints.

The solution of the so-called bailout problem without a special tax at the corporate level—which I understand is now being regarded as feasible—will meet another general and merited criticism.

The clarification of the treatment of preferred stock redemptions so as not to make prohibitive the use of such stock in normal corporate financing will meet another major portion of the criticism.

When these things are done, and the numerous minor drafting clarifications and corrections on which the experts are now working are finished, we feel confident that the new provisions governing corporate distributions and adjustments will be sound, intelligible, and a vast improvement over present law.

Other segments of the bill, of course, also need reworking. To mention a few:

(1) The foreign tax credit should not be narrowed to abolish existing credit for taxes which are not actual income taxes, but are presently recognized as tantamount to income taxes, which are presently imposed by provinces and other political subdivisions of foreign countries. I think the chairman said this morning that is being considerd.

The CHAIRMAN. That is correct.

Mr. CHAPMAN. The exemption from the tax on improper earnings accumulations for a corporation with 1,500 or more stockholders should be available to such a corporation without the impossible burden of ascertaining the family relationships and family stockholdings among the many stockholders.

The statutory approval of the declining balance method of depreciation should not carry with it any limitation on other proper methods.

The denial of the dividends-received credit for distributions of stock, fire, and casualty insurance companies should be corrected. I understand that correction is being made, from listening this morning.

Finally, for example, the effective date provisions might be so arranged as to permit legitimate transactions—for example section 112 (b) (6) liquidations—to go forward for a limited period under present rules so that new rules under the bill will not be applied with different consequences, whether favorable or unfavorable to the taxpayer, before such rules are fully understood. A reasonable waiting period between the adoption of the bill, in its final form, and its application to such transactions is a possibility.

Changes such as these are to be expected in the legislative process. The bill is simply more comprehensive than any previously enacted tax bill, so the changes are more numerous. But it seems to the chamber that they can certainly be made in time for the enactment of the bill.

Furthermore, no tax bill, at least that I am familiar with, has been anywhere near perfect at the time of its enactment. It will always be possible to revise and correct the new code by further amendment as its deficiencies appear—retroactively where justified—as has been the policy of Congress in respect of the existing code.

This is the first comprehensive revenue revision we have had in 25 or more years. It is a basic and far-reaching legal reform, generally admitted to be meritorious and long overdue. The Empire State Chamber of Commerce favors its passage as a measure of greatest importance to the legal structure on which our tax system rests.

Thank you. I would like to find out a little more accurately how much time we have to submit this memorandum. Could I talk to the clerk about it?

The CHAIRMAN. I wish you would talk with the clerk. We will try to get it in, if you want to get it in, because we are up against printing problems.

Mr. CHAPMAN. We will try to get it in by the deadline. Thank you.

The CHAIRMAN. Thank you.

(Mr. Chapman's prepared statement and information follows:)

STATEMENT OF ALGER B. CHAPMAN ON BEHALF OF EMPIRE STATE CHAMBER OF COMMERCE WITH RESPECT TO H. R. 8300, THE INTERNAL REVENUE CODE OF 1954

Mr. Chairman and members of the Committee on Finance, I am Alger B. Chapman, an attorney of New York and Washington, D. C. I appear on behalf of Empire State Chamber of Commerce, Albany, N. Y.

I wish to make a very brief general statement, and to secure permission to file with the committee, for inclusion in the record, a detailed technical memorandum which is still being perfected and will be completed and ready to file the first of the week.

The principal reason for my appearing personally is to emphasize as strongly as I can that enactment of the bill will represent a highly commendable and much-needed reform of the internal revenue laws.

I have been following the testimony for the last 2 weeks and have noted that, with few exceptions, witnesses have praised the bill as a whole. Nevertheless the committee has heard testimony suggesting that the bill is lengthy, complex and too much to be digested at once and that at least major portions thereof should be deferred pending further study.

It seems clear to me that it would be a grave mistake for the committee to accept this latter view. This is because—

First, a good workmanlike job of drafting has been done;

Second, the major drafting and policy weaknesses have already been discovered;

Third, there is sufficient time to correct them; and

Fourth, a great deal would be lost if the present opportunity to make the proposed reform a reality were passed by.

Much of the criticism has been leveled at subchapter C of chapter I, relating to corporate distributions and adjustments. This portion of the bill is of necessity the most complicated. Consequently, it is not so quickly understood, and is more susceptible to technical errors in preparation. The criticism should, therefore, come as no surprise.

I am familiar, however, with some of the various discussions which have been and are now going on with the joint committee and Treasury staffs, and I am satisfied that substantially all this criticism can and will be satisfactorily handled.

For example, so far as subchapter C of chapter I is concerned, the elimination of the 25 to 400 percent requirement in respect of corporate acquisitions, which I believe is now contemplated, as an elimination, will meet one of the major and most justified complaints.

The solution of the so-called bail-out problem without a special tax at the corporate level—which I understand is now being regarded as feasible—will meet another general and merited criticism.

The clarification of the treatment of preferred stock redemptions so as not to make prohibitive the use of such stock in normal corporate financing will meet another major portion of the criticism.

When these things are done, and the numerous minor drafting clarifications and corrections on which the experts are now working are finished, we feel confident that the new provisions governing corporate distributions and adjustments will be sound, intelligible, and a vast improvement over present law.

Other segments of the bill, of course, also need reworking. To mention a few—

(1) The foreign tax credit should not be narrowed to abolish existing credit for taxes which are not actual income taxes, imposed by provinces and other political subdivisions of foreign countries.

(2) The exemption from the tax on improper earnings accumulations for a corporation with 1,500 or more stockholders should be available to such a corporation without the impossible burden of ascertaining the family relationships and family stockholdings among the many stockholders.

(3) The statutory approval of the declining-balance method of depreciation should not carry with it any limitation on another proper method.

(4) The revenue laws should not attempt to police the investment of pension trust funds, which is already the subject of highly developed local law governing trust investments; or to impose limitations on the accumulation or investment of income by such funds, which must accumulate and invest income in order to finance employee retirements.

(5) The denial of the dividends received credit for distributions of stock fire and casualty insurance companies should be corrected.

(6) The rule that, after 5 years, payments by a partnership to a deceased partner's estate shall be taxable to the surviving partners and not to the estate should be reconsidered.

(7) The effective date provisions should be so arranged as to permit legitimate transactions—for example, section 112 (b) (6) liquidations—to go forward for a limited period under present rules so that new rules under the bill will not be applied with different consequences, whether favorable or unfavorable to the taxpayer, before such rules are fully understood. A reasonable waiting period between the adoption of the bill in its final form and its application to such transactions is a possibility.

Changes such as these are to be expected in the legislative process. This bill is simply more comprehensive than any previously enacted tax bill, so the changes are more numerous. But they can certainly be made.

Furthermore, no tax bill that I am familiar with has been anywhere near perfect. It will always be possible to revise and correct the new code by further amendment as its deficiencies appear—retroactively where justified—as has been the policy of Congress in respect of the existing code.

This is the first comprehensive revenue revision we have had in 25 or more years. It is a basic and far-reaching legal reform, generally admitted to be meritorious and long overdue. The Empire State Chamber of Commerce favors its passage as a measure of greatest importance to the legal structure on which our tax system rests.

Thank you.

MEMORANDUM SUBMITTED BY ALGER B. CHAPMAN, WASHINGTON, D. C., ON BEHALF OF EMPIRE STATE CHAMBER OF COMMERCE, ALBANY, N. Y., WITH RESPECT TO CERTAIN TECHNICAL PROVISIONS OF H. R. 8300 AFFECTING BUSINESS

This memorandum contains the views of the Empire State Chamber of Commerce on certain technical provisions of H. R. 8300 which affect its members in the conduct of their business. Limitations of time have necessarily curtailed the scope of the memorandum, both as to the number of subjects covered and the treatment of specific problems. Nevertheless, it is hoped that the memorandum will be of some assistance to the committee in making necessary changes in the bill.

We wish to give the bill a strong general endorsement. It is an excellent piece of legislation and would create a vastly improved revenue system. The effort to bring certainty to the income-tax field deserves the highest praise. In addition, the bill incorporates many valuable improvements in the substance of tax law, eliminating many inequities and inconsistencies and allowing greater flexibility in the conduct of business enterprises. On the negative side, the areas requiring substantial revision are suprisingly few, and the drafting errors are far less numerous than were to be expected, in view of the size and scope of the bill.

Comments and suggestions for improvement of the bill are listed below. In general, the list follows the order of the bill itself.

COMPUTATION OF TAXABLE INCOME (SECS. 1–275)

Dividends-received credit: Denial as to stock fire and casualty insurance company dividends (secs. 34 (c) (1) and 264 (a) (1)).—Under the bill, the individual exclusion and credit and the corporate deduction for dividends received are denied as to distributions from insurance companies. This exclusion, credit, and deduction, designed to minimize double taxation of corporate earnings, should be restored for dividends of stock fire and casualty companies, which pay income tax at full corporate rates.

Interest deduction: Carrying charges (sec. 163).—The bill proposes to allow a deduction for an assumed 6-percent interest element in carrying charges on installment purchases, but only where carrying charges are separately stated. Merchants frequently fail to state carrying charges separately. The purchaser's right to deduct the interest element should not depend upon whether the carrying charge is separately stated

Business bad debts: Stockholder's guaranty losses (sec. 166).—A holder of substantial stock in a corporation who is required as guarantor to pay a debt originally incurred by the corporation should be deemed to have incurred a business loss. This is the better view of conflicting cases. The bill should incorporate this view by expanding the definition of business bad debts to include this situation.

Same: Reserve method for secured obligations (secs. 166, 1035).—The bill changes present law to disallow a bad-debt loss on a secured obligation where the security is foreclosed, postponing the loss until disposition of the security. No express provision is made for treatment of secured obligations by taxpayers who use the reserve method of deducting bad debts. They should be expressly excluded from the changed treatment; existing law should be made to apply.

Depreciation: Methods other than straight line and double-rate declining balance (sec. 167).—Since the double-rate declining balance method leaves an undepreciated balance, the statutory authorization of any other method which does not at any point produce more rapid depreciation may be virtually worthless because most other methods would violate the test in the late years of asset life. This authorization should be broadened, or eliminated to avoid implied disapproval of other proper methods of depreciation violating the test.

Same: Declining balance method: substituted basis (sec. 167 (c)).—Where property is first used after December 31, 1953, not only the original user, but also any donee or other person acquiring the property at the original user's basis, should be permitted, at his option, to continue the declining balance method of depreciation. No abuse of the acceleration privilege would appear likely to result. Section 381 (c) (6), relating to corporate carryovers of depreciation methods, carries out the recommended principle only to a very limited extent.

Accelerated amortization: Stream and air polution control expenditures (to follow sec. 169).—Incentive to augment stream and air pollution control facilities throughout the country can and should be given by granting accelerated amortization for the cost of these facilities. Since they produce no income, it appears inappropriate to require depreciation over their useful lives.

Charitable contributions: Carryover of excess over allowances (sec. 170).—Corporations sometimes exceed the 5 percent limit on charitable contributions through overestimates of the current year's income. As an inducement to maximum charitable giving, corporations should be allowed to carry forward excess contributions to succeeding taxable years.

Charitable contributions: Unlimited deduction (sec. 170 (b) (1) (C)).—The bill allows an unlimited charitable deduction to any individual the sum of whose charitable contributions and income taxes during the taxable year and 9 of the 10 preceding taxable years exceeds 90 percent of his taxable income for the respective years. This is a highly desirable liberalization of present law, which required that the 90-percent test be met for all of the 10 preceding years. A taxpayer might for a period of years make very substantial charitable gifts in order to qualify, and then discover that, by reason of an unexpected redetermination of his income, he had inadvertently missed qualification in a particular year and be required to start over. Thus, a period of nearly 20 years would be required.

Loss carryovers: Limitations (sec. 172).—The bill perpetuates certain adjustments to net income required in determining net operating loss carryovers. They include disallowance of the 85 percent dividends received credit of corporations and of the excess of percentage depletion over cost depletion. These adjustments partially defeat the purpose of the dividends received credit and of percentage depletion by denying full benefit of them to corporations with widely fluctuating income. The adjustments should be eliminated.

The bill takes a short step in this direction by removing the adjustments with respect to the first carryback year (sec. 172 (b) (2)). Since the carryback or carryover deduction of any year is determined under the bill by the law applicable to that year, this change will be effective only with the carryback of 1956 losses to 1954. No reason exists for this delay. The bill should be amended to make the change effective for the carryback of 1954 losses to 1952.

Dividends received deduction for corporations: Income limit (sec. 246 (b)).—Section 246 (b), limiting the dividends received deduction to 85 percent of taxable income, should be eliminated. The limitation improperly denies the benefit of the deduction to corporations with fluctuating income and losses. In no event should this limitation be applicable to the 100 percent deduction provided by section 332 (b) (1).

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (SECS. 301–391)

Distributions by corporations: General discussion (secs. 301–312).—The major revenue problem in this area is to prevent ultimate distributions of earnings without dividend tax through nontaxable stock dividends, recapitalizations reorganizations, and redemptions. The technique the bill adopts to meet this problem, broadly stated, is as follows:

1. It permits distributions of stock tax-free, and taxes as dividends all distributions of securities (except in exchange for equivalent securities).
2. It allows capital-gain treatment to all sales of participating or nonparticipating stock, whether or not issued as a dividend.
3. It taxes as dividends, except in certain limited cases, all redemptions of participating and nonparticipating stock of holders of participating stock, unless a substantial change in the proportionate ownership of participating stock results.
4. It imposes on corporations an 85-percent transfer tax on any redemption, within 10 years of issuance, of dividend preferred (and like preferred issued in reorganizations), and on excessive premium on any redemption of other preferred, except where the redemption is taxed as a dividend.

The committee has received many valid critcisms of this plan, pointing out the flaws in detail; and it is not necessary to restate them. Most of the unfortunate results in particular situations are attributable to two basic element in the approach:

1. Use of a transfer tax on the redeeming corporation to collect a tax more properly imposed on the shareholder.
2. Treatment of redemptions of participating and of nonparticipating stock of holders of participating stock in the same way and, in doing so, failure to make proper allowance for situations where nonparticipating stock is owned in substantially different proportions from participating stock.

In our opinion this plan should be altered fundamentally. We understand that the joint committee and Treasury staffs are at work on basic changes. Of the several substitute proposals with which we are familiar, we recommend the following:

1. Permit distributions of stock tax-free.
2. Tax, as dividends, redemptions of participating stock which are not substantially disproportionate, except in specified exceptions.
3. Tax, as dividends, premiums in excess of a reasonable premium (possibly 20 percent) paid on redemption of future issues of nonparticipating stock for which money or property is paid in.
4. Tax, as dividends, sales, or redemptions by or from the recipient (or properly defined transferees having a carryover basis) of nonparticipating stock issued

   (*a*) as a dividend, or

   (*b*) in a reorganization (or recapitalization) in exchange for participating or dividend nonparticipating stock to shareholders who hold and continue after reorganization to hold over 50 percent of the participating stock of the reorganized business,

   except to the extent that the participating stock to which such nonparticipating stock was related has been previously disposed of. The dividend should be limited to the shareholder's proportionate share of earnings and profits at the time of issuance of the stock. Proper provision will be necessary for adjustments to basis, redemptions to pay death taxes, and similar problems.

It would seem unreasonable to apply the new rules to preferred issues of publicly held and listed companies already outstanding. Tax abuses have not been characteristic of public financing and there was no means of anticipating the proposed tax results when these issues were brought out.

The comments on sections 301 to 312 which follow are of a more detailed nature and will apply, of course, only to the extent that these sections are retained.

Distributions of securities and property: Basis of intercorporate dividends (sec. 301).—Intercorporate property dividends are limited to the adjusted basis of the distributed assets; presumably, the receiving corporation takes over the basis of the distributing corporation. However, the statute does not expressly so provide.

Same: Distribution of securities as dividend (secs. 301 and 312).—Inadvertent omission of the words "or securities" in section 312 (a) (1) would permit tax-free distribution of securities in all circumstances and should, of course, be corrected. The same omission occurs also in sections 302 (b), 305 (c) (1) (B), 305 (c) (2), 307 (a) (2), and 352 (a).

Same: Distribution of securities in exchange for securities.—No provision is made in sections 301 to 312 for the tax treatment of a distribution of securities in exchange for securities not connected with an acquisition or separation. Section 301 appears to be the proper place to repair this omission.

Distributions in redemption of stock: Exclusion of inventory assets (sec. 302 (a)).—The exclusion of distributions of inventory assets from treatment as distributions in exchange for stock should be stricken from section 302, as the exclusion apparently has the effect of taxing these distributions in all cases as dividends, contrary to the plan of subchapter C.

Same: Redemptions of nonparticipating stock disproportionate to participating stock (sec. 302 (a)).—Various owners of participating stock of a corporation frequently have radically different relative interests in its nonparticipating stock. For example, where 2 individuals each own 50 percent of a corporation's participating stock, 1 may own all of its nonparticipating stock. A redemption of nonparticipating stock should clearly not be treated as a dividend in those circumstances. The bill should be revised to permit redemption, without dividend tax, of nonparticipating stock of participating shareholders disproportionate to their respective interests in participating stock.

Same: Treasury stock in disproportionate redemptions (sec. 302).—Relative percentages used in determining whether a redemption is disproportionate should be determined by reference only to shares other than treasury stock.

Same: Interest termination: 10-year look-back (sec. 302 (c)).—This provision is apparently intended to operate as follows: Where a redemption completely terminates a stockholder's interest in the absence of attribution, and would not have terminated his interest if attribution had been applied, acquisition of an interest in the corporation, except by bequest or inheritance, within 10 years thereafter will retroactively cause attribution to apply; while this will disqualify the original redemption as a complete termination, dividend tax will result only if it did not qualify as an exchange alternatively under one of the other provisions. The language of section 302 (c) leaves this result obscure and should be clarified.

Same: Interest termination: 10-year look-back: effect of dividend tax (sec. 302 (c) (2)).—Retroactive imposition of dividend tax under section 302 (c) (2) creates several unresolved problems which must be met:

1. The intention stated in the committee report of allowing credit for any capital gains tax paid at the time of the original distribution should be carried out.
2. The distributee should be given a tax benefit in some way for the basis of the redeemed stock.
3. The retroactive adjustment to earnings and profits resulting under section 310 may, of course, alter the tax treatment of intervening distributions and add complications which should be considered more carefully.

Same: Interest termination: Application of attribution in case of gifts within 10 years (sec. 302 (c) (3)).—The bill applies attribution in determining whether a distribution qualifies as a termination of interest where the distributee has made or received a gift of stock within the preceding 10 years, unless "the transaction did not have as one of its principal purposes the avoidance of income tax." This provision needs two refinements:

1. The quoted language should be revised to say what presumably it means—avoidance of income tax on the redemption, and not merely the normal avoidance of income tax through lower surtax rates which might accompany a family gift.
2. Gifts which give rise to attribution should be restricted to gifts within the attribution group; otherwise, even such gifts as those to charity might give rise to attribution.

Redemption of stock to pay death taxes: 35- and 50-percent value requirement (sec. 303).—It should be made clear that the requirement that the value of stock be more than 35 percent of a decedent's gross, or 50 percent of his taxable, estate

in order to permit redemption of the stock to pay death taxes refers to the value of all the stock of the corporation included in the decedent's estate and not to the amount redeemed.

Same: Aggregating stocks for value test (sec. 303 (b) (2)).—Permission to aggregate stocks of several corporations in meeting the value test for redemption is granted only where 75 percent of the stock of each is included in the decedent's estate. While an improvement over present law, this is an inadequate relief provision because the ownership requirement is too high. The percentage should be lowered to 50 percent.

Redemptions through related corporations as dividends (sec. 304).—Purchase of stock of one related corporation by another is treated as a redemption of stock of the latter and, unless substantially disproportionate, is to be taxed as a dividend to the extent that the purchasing corporation has earnings and profits. This provision appears to require several refinements:

1. Consideration only of earnings and profits of the purchasing corporation in determining whether there is a dividend leaves a loophole; acquisition by a corporation having no profits can siphon earnings out of the enterprise without tax. Possibly earnings of both corporations should be considered.
2. The purchase should be protected from dividend tax, not only as to any stockholder from whom the purchase meets the test of substantial disproportion but also when it meets any of the other applicable tests of section 302.
3. The purchase being considered a redemption of stock of the purchasing corporation, provision must be made with respect to basis for gain or loss in the event the redemption is not a dividend.
4. The problem of how much stock each corporation is considered to have outstanding after the transaction in both dividend and nondividend situations must be met.

"Boot" distributions: General criticism (sec. 306).—It is understood that this section, providing the tax consequences of distributions of securities or property in connection with distributions of stock, corporate acquisitions and separations, and distributions of stock and securities of controlled corporations, is to be entirely redrafted. Its present meaning is too uncertain to permit detailed comment. However, in connection with the redrafting, the following suggestions are made:

1. The decision to tax all securities as "boot" in all situations where they are not distributed in exchange for other securities—a departure from present law—should be reconsidered. This treatment may be appropriate in recapitalizations to accord with treatment of issuance as a dividend. It is far less appropriate in some other types of reorganization where a line should probably be drawn between long- and short-term securities.
2. The treatment of distributions made with respect to securities in connection with mergers or corporate acquisitions should be revised so as to be the same whether or not the security holder is also a shareholder.

Effect on corporation of distribution of LIFO inventory (sec. 308 (b)).—The bill provides that, where the LIFO inventory method has produced a lower inventory valuation than if LIFO had been used, a corporation distributing inventory shall recognize taxable gain on the difference. This provision should be removed. It improperly requires inclusion in income of unrealized appreciation in inventory.

If this rule is retained, there should be a provision in this or some other section for stepping up the basis of the recipient shareholder as a result of this recognition of corporate gain.

Transfer tax on redemptions of nonparticipating stock: Application to existing issues (sec. 309).—The transfer tax should not be applied to existing issues. Its application to all amounts distributed in excess of 105 percent of cost would work injustice through widespread inability to prove the cost of very old issues. Its application to stock issued years ago as a dividend with a fixed redemption date will impose a severe retroactive penalty which cannot be escaped.

Same: Application to publicly held corporations (sec. 309).—The real purpose of section 309 is to prevent tax-free redemptions, after sale, of dividend stock which would be taxed under section 302 if redeemed before sale. Since stockholders of publicly held corporations will seldom, if ever, be able to act in concert on a plan which, to avoid section 302, must include a nonparticipating stock dividend, a sale of the stock, and a redemption, publicly held corporations might properly be excluded from the application of section 309.

Same: Application to all distributions in excess of 105 percent of securities or property for which the stock was issued (sec. 309 (a) (3)).—The application of the transfer tax to all distributions in excess of 105 percent of the property or securities for which the redeemed stock was issued imposes too low a ceiling on redemption premiums. Legitimate redemption premiums are sometimes as high as 20 percent. The ceiling on redemption free of transfer tax should be raised to 120 percent of the price of the stock. To resolve an ambiguity as to the effect of underwriting costs, it should be made clear that the amount for which nonparticipating stock is considered to have been issued is the amount paid by the subscriber, not that received by the corporation.

Same: Attribution in determining whether section 302 applies (sec. 302, 309, 311).—The transfer tax applies only to any redemption not taxed as a dividend under section 302; consequently, the corporation would be required to determine whether the redemption of each shareholder's stock constituted a dividend. This would be virtually impossible for a widely held corporation. It would necessitate applying family, trust, partnership, and corporate attribution in determining whether each stockholder of redeemed shares owned more than 1 percent of its stock and also whether, as to each such stockholder, the redemption was disproportionate.

Attribution of ownership under subchapter C: Corporations, trusts, estates (sec. 311).—For the purposes of subchapter C, where attribution is called for, the owner of more than 50 percent of the stock of a corporation is charged with all stock owned by it, and a beneficiary with an actuarial interest of more than 50 percent or a right to more than 50 percent of the income of an estate or trust is charged with all stock owned by the estate or trust. The attribution rule used elsewhere in the bill, under which stockholders and beneficiaries generally are charged with a proportionate interest in stock owned by their corporations, estates, and trusts, seems preferable.

Definitions relating to distributions: Participating stock (sec 312 (b)).—Participating stock is defined as stock with no preference over any other stock as to distributions of earnings or distributions of assets in liquidation and with an interest in earnings not limited to a stated amount. This definition makes it possible for corporations to have nothing but nonparticipating stock by giving a preference of some sort to every issue and thereby to avoid the intended impact of various provisions of subchapter C. This should be corrected by giving nonparticipating stock a restricted definition; participating stock should be everything else (other than securities).

Definitions: Securities (sec. 312 (c)).—Securities are defined in section 312 to exclude indebtedness on which interest is contingent, dependent in amount on earnings or which, if held by persons holding 25 percent or more of the participating stock, is subordinated to claims of creditors. This definition requires changes in two respects:

1. It should be broadened. It does not include all issues which are basically bonds, and will permit tax-free distribution and deny deduction of interest on these issues.
2. The possibility should be eliminated whereunder an issue subordinated to claims of creditors can be distributed to stockholders tax free as nonparticipating stock, and, after sale by the stockholders, become a security, the interest on which will be deductible.

Liquidations: Gain of loss to corporate shareholder: Necessity for valuing subsidiary's assets (secs. 331, 334).—Under section 112 (b) (6) of the 1939 code, liquidation of subsidiaries is quite simple, since no gain or loss is recognized. Under sections 331 and 334, these liquidations will be vastly more expensive and cumbersome, because of the recognition of gain or loss in many cases. Valuation of the subsidiary's assets will apparently be necessary in most cases in order to determine whether there is gain or loss and, if so, how much, and in order to make allocations of basis. The departure from the existing policy or complete nonrecognition of gain or loss apparently is motivated primarily by a desire to provide in the statute for the correct treatment of a purchase of stock to acquire assets, immediately followed by liquidation. Possibly this situation should receive special treatment instead of entailing a general change in rules for the liquidation of subsidiaries.

Same: Denial of loss to a corporation where the liquidated company's stock was acquired pursuant to section 359 (b) (sec. 331 (c)).—There should not be complete denial of loss on the liquidation of a subsidiary where the latter's stock was acquired in a corporate acquisition of stock under section 359 (b). The apparent reason for the proposed denial of loss is that upon the original acquisi-

tion the basis of the stock was pegged at the adjusted basis of the assets of the corporation now being liquidated. Therefore, to the extent that the value of the assets at the time of the original acquisition was less than the adjusted basis, any loss on subsequent liquidation would be artificial. However, to make proper allowance for subsequent declines in value, the denial of loss should be limited to any excess of the stock basis over the value of the subsidiary's assets on the date of the stock acquisition.

Liquidations: Treatment of gain to corporate shareholder as dividend (sec. 332 (b)).—The bill treats a corporate shareholder's gain on liquidation of another corporation as a dividend, with a special 100 percent dividends received deduction where the latter is a subsidiary. This provision requires several changes to make it function properly:

1. Proper treatment must be accorded to gain of a domestic corporation on liquidation of a foreign corporation and gain of a foreign corporation, not engaged in trade or business here, on liquidation of a domestic corporation.
2. The net income limit on the dividends received credit should be raised to 100 percent for this purpose (see sec. 246).
3. Liquidation dividends should be excluded from personal holding company income.

Same: Corporate shareholder's loss on liquidation of affiliated corporation (sec. 332 (b) (2)).—Section 332 (b) (2), which gives a corporate shareholder a capital loss on the liquidation of a corporation, should be modified to allow an ordinary loss on liquidation of an affiliated corporation, as defined in section 165 (g) (3). This is consistent with the provisions of section 165, allowing an ordinary loss on worthlessness of securities of an affiliate, and is required in order to avoid injustice in the lowering of the depreciation basis for assets and the reduction of net operating loss carryovers under section 381 (c) (1) (B) to the extent of the loss.

Same: Attribution to shareholders of corporate gains on liquidation sales (sec. 332 (c)).—The attribution to shareholders of the gain on a corporate sale of assets in liquidation which is not recognized to the corporation should be revised to provide for offsetting of losses against gains and attribution of the net gains. The bill's splitting of the losses and the gains may leave the corporation with losses from which it derives no tax benefit.

Same: Nonrecognition of corporate gain from liquidation sales: Exclusion of inventory assets (sec. 333).—The decision not to extend nonrecognition of corporate gain to sales of inventory assets should be reconsidered. The bill's continued recognition of gain on corporate sales of inventory assets in liquidation makes imposition of a double or single tax continue to depend upon the adroitness of the taxpayers involved.

Same: Shareholder gain in realizing upon inventory assets (sec. 333 (c), 336 (d)).—The bill lacks a provision for tax treatment of a shareholder's disposal of or realization upon inventory basis. The cryptic statement of section 333 (c) that they shall upon realization be deemed "inventory assets" is not enough, even when read with all other relevant provisions, to carry out the committee's stated intention that the assets shall retain individually the character they had in the hands of the corporation.

Liquidations: Basis of assets received (sec. 334 (a)).—Under the bill, where gain on liquidation is measured by the adjusted basis of the corporate assets, the shareholders take over each asset at its corporate basis. This may produce inconsistent and inequitable results among shareholders where some receive assets of high basis and low value and others receive assets of low basis and high value. Further consideration should be given to use of a basis determined by allocating the aggregate corporate basis among the assets according to their respective fair market values at distribution.

Same: Definitions; inventory assets (sec. 336 (d)).—The term "inventory assets" is defined to include depreciable property used in a trade or business and held for less than 5 years. Ordinarily sale of such property produces capital gain; hence there is little point in including it as a broad class in inventory assets; to do so works great hardship on stockholders who acquired stock after the appreciation in value occurred. If the purpose of inclusion is to obtain proper tax treatment of movies and similar assets generally involved in collapsible corporation situations, the inclusion should be restricted to assets created by the corporation.

Same: Definitions; partial liquidation (sec. 336 (a)).—The definition of "partial liquidation" is far more restrictive than the prevention of dividend tax avoidance requires, and should be broadened in several respects:

1. The requirement of operation for 5 years as a "separate business" should be removed and genuine contractions of a single business permitted.
2. The requirement that separate books have been maintained for 5 years should be eliminated.
3. The requirement of complete termination of the business should be clarified to indicate that only termination of the corporation's interest in the business is meant, and that distribution of the business to the shareholders will qualify.
4. The requirement that 90 percent or more of the gross income of at least 2 of the businesses, including the terminated business, be other than personal holding company income, should state how personal holding company income not earned as a part of any of the businesses is to be attributed to them.

Spin-offs, split-offs, split-ups: General discussion (sec. 353).—Under existing law, where a spin-off is used as a device to siphon off earnings and profits or it is intended that one of the corporations will not engage in active conduct of a business, the shares distributed are taxed as a dividend. The bill extends the coverage to split-offs and split-ups, uses more detailed and considerably more-inclusive tests for the type of distribution which may be a dividend-siphoning device, and makes a basic departure in remedy. Ordinary income tax is not imposed on the distribution of the shares. Instead, both corporations are scrutinized for 10 years and, if either is an "inactive corporation" during this period, ordinary income tax is imposed on the shareholders on realization of money or property through distributions from the corporation or disposal of its shares. The resulting complexities and possible loopholes and inequities make the wisdom of this approach to the problem doubtful. Further consideration and exploration of other solutions is recommended.

The remaining detailed comments on section 353 will apply only to the extent that its provisions are not changed by a more basic revision.

Same: Stock acquired within the preceding 5 years by transfer of assets to a controlled corporation (sec. 353 (a)).—It is not clear whether the denial of tax-free spin-off of stock acquired within 5 years preceding the distribution by a transfer of assets by the distributing corporation to a controlled corporation under section 351 applies to transfers prior to the effective date of the bill. The denial applies to stock acquisitions within the preceding 5 years to which "section 351 is applicable." If coverage is intended of transfers prior to the effective date of the bill, more appropriate language would be "of the type described in section 351."

Same: Requirement of distribution of all stock (sec. 353 (a) (1)).—The requirement that the parent company distribute all stock and securities of a controlled corporation in order to qualify the distribution as a tax-free spin-off should be eliminated. It is a departure from existing law which appears unnecessary. It will prevent legitimate spin-offs where the parent corporation is precluded by contract or otherwise from disposing of all the stock.

Same: Definition of inactive corporation (sec. 353 (c)).—The definition of an "inactive corporation," which cannot be created in a spin-off without dividend tax or other possible penalties, involves tests similar to those required for a partial liquidation under section 336 (a). The changes suggested as to section 336 (a) should also be made in the definition of "inactive corporation" in this section.

Same: Distributions by, or disposition of stock of an "inactive corporation" (sec. 353 (b)).—The details of the treatment of distributions from an "inactive corporation" or disposition of its stock, within 10 years after a spin-off, should be elaborated in the following respects:

1. The disposal of stock should be taxed as a capital gain, rather than ordinary income, where accompanied by disposal of the underlying stock upon which the stock of the "inactive corporation" was distributed.
2. The spinning off of stock of a corporation controlled by a spun-off "inactive corporation" should be tax free, although all corporations will, of course, remain subject to the restrictions of section 353. To authorize this spin-off from an "inactive corporation," section 353 (b) (2) should be modified to provide that a spin-off shall not be considered a distribution within section 353 (b) (2).

3. The provision that amounts received as distributions from an "inactive corporation" or upon disposition of its stock shall be "includible in income" does not accord the benefit of the dividends received exclusion and credit. Since the reason for tax is that the payments are essentially dividends, the exclusion and credit should be allowed.

4. The shareholder who is taxed on the complete proceeds of disposal of stock of an "inactive corporation" should in some way be granted tax benefit from his basis for the stock. Perhaps the tax under section 353 (b) should be only upon the excess of sale proceeds over basis.

5. Income taxed on disposal of an "inactive corporation's" stock should be limited to the shareholder's proportionate share of the earnings and profits of the distributing corporation at the time of the spin-off.

Statutory mergers and consolidations: Restriction to publicly held corporations (sec. 354 (b)).—The benefits of nonrecognition of gain on statutory mergers and consolidations should be accorded to all corporations, as under existing law, instead of to publicly held corporations only.

Assumption of liability: Nonrecognition of gain; exchanges of investment property (sec. 356).—The bill provides that assumption of a taxpayer's liability or acquisition from him of property subject to a liability shall not be considered as money or other property received by the taxpayer in certain types of exchanges, in the absence of tax-avoidance motives. Consideration should be given to including exchanges, under section 1031, of property held for productive use or investment.

Liquidation followed by reincorporaton: General discussion (sec. 357).—The bill seeks to prevent the drawing of corporate profits without dividend tax through a complete or partial liquidation followed by reincorporation of the business minus nonbusiness assets. Reincorporation by controlling shareholders within 5 years of 50 percent or more of the assets received in a liquidation gives rise to a dividend tax on the assets received in liquidation but not reincorporated. The reincorporation is treated as though the new corporation had received assets from the liquidating corporation in a corporate acquisition of property. However, to function properly, the section requires several changes:

1. The dividend should be measured by the value of the assets at the time of the liquidation, rather than at the time of reincorporation, as the bill appears to provide.
2. Credit should be given against income tax for capital-gain tax paid with respect to the assets taxed as a dividend.
3. Tax benefit should be afforded in some way for the basis of these assets.
4. The basis of the reincorporated assets to the new corporation should be clarified.
5. Where the liquidation was partial, it should be specified as of what date earnings and profits of the liquidating corporation are to be determined for the purpose of ascertaining the extent of the dividend.
6. The effect of various possible types of intervening transactions should be carefully considered and specified.

Corporate distributions and adjustments: Foreign corporations (sec. 358).—The transfer of property by a foreign corporation to a domestic subsidiary in exchange for the latter's stock is made taxable under this section, in the absence of a ruling from the Secretary that no tax avoidance is intended. This departs from present law, makes formation of domestic subsidiaries by foreign corporations unduly cumbersome, and should be changed.

Definitions: Corporate acquisitions of stock; 25 to 400 percent rule (sec. 359 (b) (2) and (c) (1).—The bill adopts a novel rule, commonly known as the 25 to 400 rule, for corporate acquisitions of stock or property in return for stock. It requires that shareholders of a corporation stock or property of which is acquired must own after the acquisition no less than 25 nor more than 400 percent of the amount of stock of the acquiring corporation owned by the stockholders of the acquiring corporation or any other acquired corporation. The effect of the rule is to prevent tax-free acquisitions of small corporations by large ones. We understand that the rule is to be abandoned; hence there is no need of further discussion except to add, for emphasis, complete agreement with its elimination.

Carryovers in corporate acquisitions: Net operating losses in liquidations (sec. 381 (c) (1) (B)).—The bill requires that the net operating loss carryovers from a liquidated subsidiary be reduced by the amount of the loss recognized to the parent in the liquidation. This requirement is inequitable, unless the parent's

liquidation loss under section 332 (b) (2) is changed from capital to ordinary. If it is not changed, the parent should be permitted to elect not to recognize the loss.

Same: Capital losses in liquidations (sec. 381 (c) (3) (D)).—The capital loss carryover from a subsidiary should not be totally denied to a parent who suffered a capital loss on the liquidation of the subsidiary; the equitable rule is to diminish the carryover by the liquidation loss.

Same: Prepaid income and assumed obligations (sec. 381 (c) (7) and 16)).—The bill treats inconsistently prepaid income not yet reportable and deductions not yet deductible. As these items are realized, the acquiring corporation is required to report the prepaid income even though he paid the traansferor for it, but cannot claim the deduction if he was allowed credit for it in the purchase price. This inconsistency should be resolved.

Same: Emergency amortization deductions (sec. 381 (c)).—Provision should be made in the listing of carryovers in section 381 (c) for the carryover of the right to claim amortization deductions for emergency facilities and grain-storage facilities.

Effective date of subchapter C (sec. 391).—The effective date provisions of this subchapter require careful reconsideration. Substantial changes in various parts of the subchapter will doubtless make March 1 an inappropriate effective date for most purposes. As to part II, dealing with corporate liquidations, and part III, dealing with corporate organizations, acquisitions, and separations, confict may exist between the desire to give taxpayers early advantage of the new provisions and the problem that pending transactions may be stultified until the new rules are thoroughly understood. An appropriate solution appears to be to give taxpayers an option to carry out parts II and III transactions under either present law or the new code for a reasonable transition period. If this solution is impracticable, an effective date for these parts approximately 90 days after enactment is clearly preferable to any earlier date.

ACCOUNTING PERIODS AND METHODS (SECS. 441–482)

Inventories: Treatment of supplies consumed in production (sec. 471).—The bill should correct the existing distinction in inventory treatment of materials used in production which become a part of the finished product and those which do not. This unwarranted distinction can be eliminated by permitting use of the lower-of-cost-or-market method as well as of the last-in first-out method of valuation for supplies consumed in a productive process.

Same: Use of lower of cost or market valuation where LIFO is used (sec. 472).—LIFO inventories must be valued at cost under present law and under the bill. Allowance of LIFO valuation at the lower of cost or market would permit taxpayers more clearly to reflect income in periods of declining prices.

Accounting methods: Adjustments required by change (sec. 481).—The Secretary is given discretion to make appropriate adjustments to prevent omission or duplication of items incident to a change in a taxpayer's method of accounting. Since the necessary adjustments are ordinarily self-evident, and since they may be necessary to protect the taxpayer as well as the Treasury, the bill might well provide simply that proper adjustments must be made instead of leaving the matter to the Secretary's discretion.

The provision of section 481 for spread of an increase in income due to these adjustments does not appear to provide for the converse situation where income is artificially depressed by an adjustment made to prevent omission of a deduction or duplication of an income item. Proper provision should be made for the spread of the effect of these income-depressing adjustments.

EXEMPT ORGANIZATIONS (SECS. 501–526)

Exempt organizations: Liquidations (secs. 501 et seq.).—The bill should clarify the tax-exempt status of an exempt organization during the period of termination of its activities, disposal of its assets, liquidation, and dissolution. The fact that at some point in this process its regular activities are necessarily terminated should not cast doubt upon its tax-exempt status during the period immediately preceding final dissolution. So long as the disposal of its assets and winding up of its affairs proceed in an orderly manner and with reasonable dispatch, it should be clear that the organization is entitled to its exempt status until dissolution. It is believed that present law achieves this effect, but a statutory amendment clarifying the situation is desirable.

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS (SECS. 531–564)

Surtax on improper accumulations: Percentage ownership limit in determining exemption (sec. 532).—A corporation with 1,500 or more stockholders should qualify as publicly held even where 1 individual owns more than 10 percent of its stock. The 10-percent limit would deny the exemption to many corporations in which sufficient concentration of ownership does not exist for control of dividends in order to avoid surtax. Therefore, this limit should be increased as to percentage, or removed.

Same: Attribution rule in determining exemption (sec. 532).—The attribution rule should be removed from the ownership test for corporations with 1,500 or more stockholders so as not to impose on these corporations, in qualifying for the surtax exemption, the impossible burden of ascertaining family stockholdings among their many stockholders. A limit on ownership by a small stated number of persons, irrespective of relationship, would be a workable substitute.

Same: Exemption for subsidiaries (sec. 532).—The bill gives no test for exemption of subsidiary corporations from the surtax. Subsidiaries which meet the test for affiliation should be exempt where the parent is publicly held. It should be made clear, also, that the surtax is aimed at avoidance of the individual, rather than the corporate, income tax.

Same: Investments in new business (sec. 533).—Under existing law, investment of earnings in a new business, whether through acquisition of assets or of stock control, is considered to be a proper use of earnings justifying accumulation. The Ways and Means Committee report contains language which recognizes this, as do also the present regulations. (Reg. 118, sec. 29.102-3; House Rept. No. 1337, 83d Cong., 2d sess., p. 53.) There should be no question, therefore, that the healthy expansion of business through addition of new lines is entirely proper. Nevertheless, the Finance Committee and conference committee should also state very clearly the intent of Congress that the investment of earnings of a corporation in any new operating business, whether through acquisition of assets or of stock control (80 percent), is an employment of the income in its business for purposes of the special tax on surplus accumulations. There should be no doubt left on this score, and failure to treat the matter after the reference thereto in the House report might create such a doubt.

Same: Burden of proof in refund cases (sec. 534).—Where certain conditions are met, the bill places the burden of proof as to the issue whether earnings have been accumulated beyond the reasonable needs of the business on the Commissioner in Tax Court proceedings. The burden of proof on this issue should, in the same circumstances, be on the Government in tax-refund suits as well.

RETIREMENT INCOME; ACCIDENT AND HEALTH PLANS: EMPLOYEES' PLANS AND TRUSTS

(SECS. 38, 101, 105, 401–403, 501 (e), 504, 505, 514, 2039, 6033)

Retirement income: Inclusion of income from profit-sharing and stock-bonus plans (sec. 38 (c)).—Section 38 (c) (1) includes in "retirement income" income from pensions and annuities. There is no reason for failing to include also payments from profit-sharing and stock-bonus plans or trusts. These kinds of payment should also be entitled to the retirement income credit.

Death benefits: Employee-plan payments (sec. 101 (b) (2)).—Section 101 (b) (2) (B) excludes from gross income $5,000 of total distributions under a profit-sharing or stock-bonus trust paid as death benefits. This exclusion should apply to any distribution, whether paid in a lump sum or in installments, under a pension, profit-sharing, or stock-bonus plan or trust. There is no reason to discriminate against pension payments, or nontrusteed employee plans, or periodic distributions from such plans or trusts.

Same: Deduction by employer of death-benefit payments (sec. 101).—The bill should make it clear that death-benefit payments by employers are fully deductible when made, including the first $5,000 of such payments.

Employers' accident and health plans: Requirements for qualification (sec. 105 (c) (1) (C)).—As now written, this section gears the requirements for qualification of employers' accident and health plans to inappropriate tests of section 501 (e) (4). Such plans should be required to meet the "coverage" tests of section 501 (e) (3), but not the proportionate contribution and benefit tests of section 501 (e) (4). Apart from coverage, qualified employers' accident or health plans need not be regulated; this is not a likely area of discrimination or other abuse.

Same: Definition of "compensation for loss of wages" (sec. 105 (b), (C)).—To avoid questions of whether payments under plans are for loss of wages or for doctors and hospital bills, etc., "compensation for loss of wages" should be defined to include all amounts paid to employees or other persons (e. g., beneficiaries, dependents) except amounts paid as reimbursement for actual medical expenses. This definition would place a burden on the employee to establish that payments received were in reimbursement of medical expenses; on the other hand, it would prevent all direct receipts from being treated automatically as compensation for loss of wages.

Same: Permissible beneficiaries (sec. 105).—The present section seems to be limited to amounts received by employees only. This is probably an oversight; there is little reason not to recognize plans benefiting dependents of the employee. Under employer-provided "Blue Cross" plans, for example, coverage ordinarily extends to entire families. Certain other employers' plans include all persons living in the employees' household.

Same: Subtraction of "nonqualified compensation" from compensation for loss of wages (sec. 105).—The policy of reducing the $100 exclusion for "qualified" compensation for loss of wages by the amount of "nonqualified compensation" received is highly questionable. If it is deemed necessary to penalize receipt of "nonqualified compensation," it should be made clear that amounts paid for loss of wages under a qualified plan in excess of $100 shall not affect or reduce the $100 exclusion, that is, that no part of amounts paid under a qualified plan shall be regarded as "nonqualified compensation." Subsection (c) (2) of section 105 is ambiguous in this respect.

Employee annuities and employee trusts: Capital gains on "termination of the plan" (secs. 401, 402).—Under sections 401 (b), and 402 (a) (2), provision is made for capital gains treatment of total distributions from a plan under various conditions, including the termination of the plan because of a complete termination of the business. Plans may justifiably be terminated for a variety of business reasons. It seems harsh to penalize the employee who receives a lump-sum distribution on termination of a plan without complete liquidation of the business where the circumstances are beyond his control. This section should allow capital-gains treatment upon the termination of a plan where it has been shown to the satisfaction of the Commissioner that such termination was reasonable and not part of a design to avoid employee surtaxes.

Same: Capital-gains treatment under plans continuing to qualify under section 165 of the present code (secs. 401, 402).—The capital-gains treatment afforded to employees under sections 401 (b) and 402 (a) (2) should be explicitly made available to plans and trusts continuing to qualify under section 165 of the 1939 code rather than under the new section 501 (e).

The general problem—extension to "old" plans of new and more favorable treatment granted to plans qualified under H. R. 8300—occurs at several points, such as with respect to capital gains (secs. 401 (b), 402 (b)), estate tax exclusion (sec. 2039 (c)), and death benefits (sec. 101). These might be best dealt with in a single section regulating all the incidents of section 165 plans and trusts remaining in effect.

Same: Constructive receipt (secs. 401, 402).—In some parts of sections 401 and 402 the phrase "amounts received" is used; elsewhere, reference is made to amounts "actually distributed or made available"; finally the word "payment" is also used. The intended meaning of all these phrases is evidently the same. A consistent reference to actual payment or actual receipt should be used throughout. The possibility of application of "constructive receipt" principles in this area should be expressly eliminated.

Employees' trusts: Employers' securities (sec. 402 (a) (3) (A) (ii)).—Employers' securities are defined to include securities of its parent or subsidiary. A subsidiary is defined as a corporation in which the employer's stock interest is more than 50 percent. It is recommended that a corporation owned 100 percent by not more than 5 corporations, each of which owns at least 10 percent of its stock, be regarded for the purposes of section 402 as a subsidiary of any of the owning corporations.

Same: Deduction for contributions to employees' plans; United States citizens working abroad (sec. 403).—Employees of domestic corporations frequently are sent abroad to work for a foreign-incorporated subsidiary. Section 403 would bar deductions by the parent corporation for contributions on behalf of such employees. It is recommended that the section be changed to permit a deduction for contributions in respect of a United States citizen who works outside of the United States for a corporation which is either a parent

or subsidiary of the United States company, as "parent" and "subsidiary" are defined above for the purposes of section 402 (a) (3) (A) (ii).

Same: Deduction for contributions to pension plans (sec. 403 (a) (1) (C)).—The deduction for contributions to pension plans provided under section 403 (a) (1) (C) should be limited to prevent deduction of contributions based on payments in prior years after past service costs are covered. Once past service costs have been met, only normal costs should be allowed as deductions.

Same: Coverage and nondiscrimination requirements for employees' trusts (sec. 501 (e) (3) (A).—In many respects section 501 (e) (3) (A), intended to liberalize the requirements for qualifying an employee's plan, is more restrictive than present law. The provisions of the new bill tend strongly to discriminate against employers, numerous union employees of whom are covered by one plan and who seek to create a second plan for salaried employees.

In view of the provisions against discrimination set forth in section 501 (e) (4), the necessity for coverage requirements may well be questioned. If, in any event, coverage is to be retained, it is recommended that 501 (e) (3) (A) be amended in several respects. The recognized classifications should be increased to include (1) all employees covered by a collective bargaining agreement, (2) all employees not covered by a collective bargaining agreement, (3) all employees subject to the Fair Labor Standards Act, and (4) all employees exempt from the Fair Labor Standards Act.

The "key employee" tests should not be applicable to the specific classes enumerated (including the additional classes proposed herein) but should be applicable only to "any other classification" set up under subsection (vii). Moreover, the key employee test is too severe as now written; we recommend that it be revised to apply only if 50 percent or more of the participants of a plan are key employees as defined in section 501 (e) (3) (B).

Same: Ratio of contributions and benefits (sec. 501 (e) (4)).—The bill defines compensation, for the purpose of measuring contributions and benefits, in terms of "basic or regular" compensation. Under existing law usual bonuses may be included in the compensation base if the bonus history of the employer is regular enough to warrant this. The new bill should recognize in the compensation base conventional bonuses, measured by the average of bonuses over a stated period of preceding years.

Subsection (A) of 501 (e) (4) should be phrased in terms of benefits only, rather than contributions and benefits, since the scale of benefits will actuarially regulate contributions. Furthermore, subsection (A) should recognize the propriety of variations in benefits according to length of service. Subsection (B) should be changed to permit allocation of forfeitures according to the ratio of balances in the trust attributable to participants as of the time of forfeitures. As now drafted, all forfeitures must be allocated strictly in proportion to current compensation of participants. Most existing plans use the "balance" method, and an allocation by balances has considerable equitable justification. Subsection (B) should also recognize the propriety of contributions geared to length of service.

Neither subsection (A) nor subsection (B) of section 501 (e) (4) specifies whether vesting of rights must take place at any particular time or by any standard. The implication is that the new bill eliminates any vesting tests for qualified plans. If this is intended, we recommend that vesting be expressly ruled out as a test of qualification.

Same: Contributory or matching plans (sec. 501 (e) (4)).—The present provisions of the bill will eliminate or drastically alter plans based in part on employee contributions or on a matching of employee contributions by employer contributions. If participants of such plans do not constitute in full, the employer's contribution ordinarily will be reduced. This may destroy the ratio of contribution or benefits required under section 501 (e) (4), and, therefore, disqualify the plan. The propriety of contributory or matching plans should be fully recognized in all respects, and neither the coverage requirements nor provisions against discrimination should be allowed to discourage such plans which would qualify under section 165 of the 1939 code.

Same: Accumulations (sec. 504).—Section 504, which is taken over from section 3814 of the 1939 code, has been expanded to include employees' trusts. Since employees' trusts, unlike charitable organizations, are bound to accumulate funds, it is hard to see in what situation an accumulation creates "jeopardy" in the sense of subsection (a) (3). If the intention is to regulate such trusts' investments, regulation should logically apply not only to accumulations but also to amounts contributed. We recommend that section 504 be made inapplicable to section 501 (e) organizations.

Same: Regulation of employee trusts' investments (sec. 505).—Section 505 of the new bill consists largely of a number of provisions taken over from section 361 of the 1939 code, there relating to regulated investment companies. However, certain of the limitations on these rules which appeared in section 361 have, for no very evident reason, been deleted.

Employees' trusts are already subject to a number of restrictions under local law with regard to investments, and may be further controlled by the particular provisions of the trust instrument. A policy of additionally restricting the investment practices of these trusts as a matter of tax law would seem unwise. This section places a tremendous policing burden upon the Internal Revenue Service. Furthermore, the draft of the section as it now stands creates a host of problems which have undoubtedly been brought to the attention of the committee heretofore. For example, the provisions would require quarterly valuations of a wide variety of assets. If certain kinds of investments proved unduly advantageous, e. g., real estate investments, they might violate the percentage restrictions imposed with respect to such investments. As a result the trust would lose its exemption, the employer would lose deductions, and income which might otherwise have been taxed to employees at capital gains rates would be subjected to normal and surtax rates. We recommended that section 505 be eliminated in its entirety.

Same: Rental income (sec. 514).—Section 514, now made applicable to employees' trusts, imposes a tax on rents derived from long-term leases on property constructed or purchased with borrowed funds. To the extent that such borrowing reflects ordinary commercial practices, there is little reason to penalize any otherwise exempt organization. Supplement U of the 1939 code was primarily addressed to "trading in tax exemptions," which does not arise where the exempt organization conforms to usual commercial standards of borrowing in order to purchase or construct properties. In any event, the application of this provision to those employees' trusts which are committed for several years in the future by long-term leases is harsh and inequitable; existing leases should be exempted.

Estate tax: Exemption of employee trust distributions (sec. 2039).—The exemption from estate tax contained in section 2039 for distributions from employees' trusts and plans should be made applicable not only to trusts and plans qualified under section 501 (e) but also to plans and trusts continuing to qualify under section 165 of the 1939 code.

Returns of exempt organization: Statute of limitations (sec. 6033).—It should be made clear that the returns filed by organizations exempt under section 501 (a) shall start the running of the statute of limitations in the same manner as regular tax returns.

FOREIGN INCOME (SECS. 901–958)

Foreign tax credit: Income taxes paid to political subdivisions (sec. 901).—Credit is allowed under the bill for income, war profits and excess-profits taxes paid to "foreign countries." The term "foreign countries" has been held to include political subdivisions as well as national governments. For clarity, the bill should provide this expressly.

Same: Credit for "principal tax" paid to political subdivisions (secs. 901–906).—Under existing law, credit is allowed for foreign taxes paid "in lieu of" income taxes at both the national government and political subdivision levels. The bill eliminates this credit for "in lieu of" taxes and substitutes a credit for the "principal tax" paid, but allows it only for payments to national governments. Credit should be allowed also for the principal tax paid at the political subdivision level.

Same: Restoration of credit for "in lieu of" taxes (secs. 901–906).—The bill's definition of the term "principal tax" is so narrow as to deny the credit for certain foreign taxes qualifying for credit under the existing allowance for taxes imposed "in lieu of" income tax. Since the purpose of introduction of the principal tax credit is to broaden rather than restrict the credit, credit for "in lieu of" taxes should be restored as a supplement to the "principal tax" credit in order to cover these cases. It is doubly important to restore the "in lieu of" credit at the political subdivision level, since no credit is allowed for the "principal tax" paid at that level.

Same: Deduction and credit for principal tax (secs. 901–906 and 164).—Under the bill, a domestic corporation receives both a deduction and a credit for a principal tax paid to a foreign country. It does not get a similar duplication

of benefits where the foreign tax is an income tax. The deduction for principal tax should be eliminated.

Same: Substitution of overall limit for country-by-country limit (secs. 902, 904).—The bill eliminates the overall limitation on the foreign tax credit and retains the country-by-country limit. This appears to be an unwise choice. The ultimate purpose of the limitation should be to prevent the credit from being used to offset tax on domestic income. Where losses in some foreign countries offset income in others, the country-by-country limitation cannot prevent this improper effect of the credit.

Same: Credit for foreign dividends where stock interest is less than 10 percent (sec. 902).—Where a domestic corporation owns stock of a foreign corporation, its dividend receipts represent income already taxed abroad, irrespective of whether its percentage interest in the foreign corporation exceeds 10 percent. The 10-percent ownership requirement denies a credit for this foreign tax. Credit should be allowed irrespective of the percentage of ownership, in order to minimize this form of double taxation.

Foreign earned income of individuals: Income limit under 17-months-residence rule (sec. 911).—Congress last year imposed a $20,000 limit on the earned income of individuals which is exempted from tax because of their presence in a foreign country for 17 out of 18 consecutive months. Experience has shown that this limit is too low, making it difficult for American business firms to obtain suitable executives for foreign service. The limit should be raised to $30,000.

Western Hemisphere trade corporations: Changes to equalize treatment with that of foreign subsidiaries and branches (secs. 921 and 922).—This class of corporations was originally given favorable tax treatment as an incentive to Western Hemisphere trade. Provisions of the bill affording favored treatment for virtually all foreign business income exclude Western Hemisphere trade corporations from certain of the new benefits, thereby placing them at a competitive disadvantage. To correct this, two changes are needed:

1. Western Hemisphere trade corporations should be permitted, like other corporations, to elect to defer taxes on branch income. If this change is made in section 951, appropriate adjustments will be necessary to preclude such corporations from obtaining a double rate reduction.
2. The deduction for dividends received by corporations from Western Hemisphere trade corporations should be increased to 100 percent. The bill perpetuates existing law in allowing corporations the regular 85-percent dividends-received deduction on dividends from Western Hemisphere trade corporations. This limited dividends-received deduction places corporations doing business through Western Hemisphere trade corporation subsidiaries at a disadvantage relative to corporations doing business abroad through either foreign subsidiaries or branches.

Same: Source of insurance recoveries on goods in transit (sec. 921).—Western Hemisphere trade corporations can qualify as such only if 95 percent or more of gross income is derived annually from sources without the United States. The Treasury has recently taken the position that insurance proceeds for loss or damage of goods in transit to the United States is income from sources within the United States. This result appears erroneous and may unjustly cause disqualification. This item should be expressly excluded from the definition of gross income in section 921.

Fourteen-point credit for foreign income: Income qualifying (secs. 923–951).—The bill restricts the 14-point credit to certain types of income. Credit is not allowed for income from wholesale establishments. This limitation appears unnecessary and discriminatory. The coverage of the credit should be broadened to include income from all trade or business carried on abroad.

Same: Compensation for technical services (sec. 923).—While the language is not clear, compensation for technical services appears to qualify for the 14-point credit only where the services are rendered abroad. The provisions should be broadened to allow the credit as to technical services wherever rendered, so long as rendered to a trade or business carried on outside the United States.

Same: Percentage ownership required as to foreign corporation (sec. 923).—The 14-point credit is allowed only where 4 or fewer domestic corporations own more than 50 percent of a foreign corporation. Frequently foreign governments insist on equal participation in enterprises granted franchises or privileges. To allow tax credit in these cases, the ownership requirement should be reduced to 50 percent or more of the stock.

Same: Percentage ownership limited by foreign law (*sec. 923*).—The laws of some foreign countries require that their citizens own a majority of the stock of all corporations. The ownership requirement for the 14-point credit should be further amended so that it is met by ownership of the maximum amount of stock permitted by the laws of the foreign country.

Same: Credit for branch income where no election (*secs. 923, 951, 953*).—The bill improperly ties the 14-point credit for income of foreign branches to an election to defer branch income. The credit should be allowed to a corporation for any branch which qualifies for election where the corporation's bookkeeping methods properly reflect branch income, irrespective of whether the election is made.

GAIN OR LOSS ON DISPOSITION OF PROPERTY (SECS. 1001–1091)

Basis: Cost of demolished improvements and expense of demolition (*sec. 1016*).—Where improved property is purchased with a view to demolition of the improvements to make way for new construction, the bill is silent as to the tax treatment of the cost of demolished buildings and expense of demolition. The Treasury rule that these costs must be considered part of the cost of the real estate impedes the rehabilitation of property. The bill should be amended to permit the purchaser to include in the depreciable basis of new improvements the excess of the sum of the total cost of the property and the expense of demolition over the fair market value of the unimproved real estate.

CAPITAL GAINS AND LOSSES (1201–1241)

Capital assets: Dealers in notes and accounts (*sec. 1221*).—The bill does not specify the tax treatment of gains and losses on notes and accounts receivable to dealers in these items. The specific exclusion from capital assets of accounts and notes receivable in the hands of those who acquired them for services or the sale of property may create confusion as to dealers unless notes and accounts in their hands are likewise expressly excluded from capital assets.

The CHAIRMAN. Mr. Dayton.

STATEMENT OF E. R. DAYTON, VICE PRESIDENT AND TREASURER, RUSSELL MANUFACTURING CO.

Mr. DAYTON. Mr. Chairman, my name is E. R. Dayton. I am vice president and treasurer of the Russell Manufacturing Co., Middletown, Conn. Our company manufactures belting and automotive friction materials and various types of narrow fabric textiles.

I should like to thank the committee for the opportunity to appear here. I have prepared a written statement which I respectfully ask be incorporated into the record of the hearings.

The CHAIRMAN. We will be very glad to put it into the record.

Mr. DAYTON. My appearance here is with reference to section 403, particularly subsection (a) (5).

Section 403 sets forth the terms and conditions under which employers' contributions to profit-sharing or deferred compensation plans, or pension plans, are deductible, and generally it provides that where a plan qualifies under other sections of the bill, the contributions are deductible in the year in which they are paid into the trust.

Subsection (a) (5) provides that where a plan is not qualified, the contributions are deductible in the years in which the contributions are distributed or made available to the employee-participants, in the plan. This represents a departure—it represents a complete reversal of the present Treasury rule.

In November 1948 the Treasury Department issued Regulation T. D. 5666, which provides in substance that contributions to a nonqualified plan are never deductible at any time unless there vests in

the employee at the time the contribution is paid an absolute right to receive his participation in that trust.

And, I am appearing here to ask that this subsection, which reverses that Treasury ruling, be made applicable to the years 1942 and subsequent years.

Now, my reason for asking that is this—and I'll summarize briefly what I have in the statement; I am not going to take very much time. Since 1942, my company has had in effect a plan of deferred compensation which is a nonqualified plan. It does not qualify as a tax-exempt trust under the provisions of the law, either now or as they existed at that time. The company, during the war was engaged very extensively in the production of war materials. The materials which it produced were specialized in nature and were things that could not be generally made by a large number of people. The contracts were rather extensive and they ran to several million dollars. So that the amount of business was much larger than the company had done prior to the war. It is a relatively small company, and has a comparatively small top executive organization. So, it was very important to the management, to the directors, to retain this organization. They were a small number of highly skilled and highly trained men who knew this particular business very thoroughly. And, to lose any of them out of the organization would have been disastrous during the war and during the reconversion period that followed.

For that reason the company devised this deferred compensation plan, under which it paid into an irrevocable trust each year a certain percentage of the net profit of the corporation, for the benefit of these specified key officers and executives. These participants were entitled to receive their portion of the compensation so paid into this trust over a period of 5 years, providing they remained in the employ of the company during that period. So that two things had to be done in order for them to receive this compensation.

First, the company had to make money in excess of a certain specified amount, and, second, they had to stay in the employ of the company. Now, this objective, therefore, was accomplished by means of this trust, which was made irrevocable.

Now, although the employees' shares in this trust were forfeitable individually, they were not forfeitable as a group, and the trust indenture specifically provided that no part, either of the principal or income, of these trusts could ever be recaptured by the company.

Now, at the time these payments were first made and these trusts were set up, at that time the company's contributions were a proper tax reduction. Later in 1942, when section 23 (p) was amended, it was provided that where payments were made into a trust, where the employees' rights were forfeitable, the payments could not be deducted in the taxable year in which they were made. Section 23 (p) said nothing about a deduction in later years, when the distribution was made, whereas it is provided now in subsection 403 (a) (5) that a deduction is allowable in the years distributions are made.

It was not until 1948, when regulation T. D. 5666 was issued, that the company became aware of the fact that it was the intention of the Treasury to disallow these deductions at any time. So, the company found itself in the position of having operated and made large payments under a plan of deferred compensation, which represented

payments of reasonable compensation to these employees, without being allowed a deduction for tax purposes, in any amount.

This was a tremendous hardship upon a small company. The amounts paid were relatively large in relation to the base salaries of these men, because the company wished to make this plan attractive to them, and for that reason the base salaries were comparatively modest, and the amounts of additional compensation which they could earn by contributing to the profitable operations of the company and remaining in its employ were relatively large. And, that is one of the reasons why the plan couldn't be qualified under the law.

Now, we do not believe, and we did not believe at the time, that Congress ever intended to deprive an employer of any deduction whatever for the payment of reasonable compensation to his employees. We went ahead under that feeling and impression and understanding until 1949. The only purpose of using a trust was to assure the employees that they would receive this compensation. The company could have accomplished the same purpose without setting up a trust. It could merely have contractually engaged with these employees to pay them these amounts in the 5 subsequent years, and there would have been no question about the deductibility of the amounts.

The mere fact that the company possibly leaned over backward in order to make the position of these men secure, that they should have perfect confidence in the fact that no unforeseen event could take place which could deprive them of this compensation, unwittingly and innocently jeopardized its ability to use these deductions for the purpose of determining its taxable income.

We do not believe that Congress ever intended that result, and we believe that the present subsection 403 (a) (5) is right, and that that is the proper way to handle this situation. We think it was intended in the 1942 law and that our plan has been right all the time.

It is our belief that, if this new section were made applicable to 1942 and thereafter, the effect on revenue would be negligible. We think, and we are sure, that there are just a very, very few companies—we know of almost no other cases where companies have been, I think innocently trapped into this position, where they find themselves laboring under this hardship, which could have been and probably was in many cases accomplished by not using an irrevocable trust, but by merely paying the money out direct to those employees. We feel it is unreasonable and discriminates against employees who took these precautions to safeguard their employee's right to receive this money in future years.

We respectfully urge that serious consideration be given to making this provision effective for the year 1942 and thereafter.

Thank you very much.

The CHAIRMAN. Thank you.

(The prepared statement of Mr. Dayton follows:)

STATEMENT OF E. R. DAYTON, VICE PRESIDENT AND TREASURER, RUSSELL MANUFACTURING CO.

My name is E. R. Dayton. I am vice president and treasurer of the Russell Manufacturing Co., of Middletown, Conn. The Russell Manufacturing Co. is engaged in the production of belting and automotive friction materials and narrow fabric textiles.

My appearance here is with reference to section 403 (a) (5) of H. R. 8300.

Section 403 sets forth the terms and conditions under which employers may deduct contributions made to pension and profit-sharing plans established by them for the benefit of their employees. The general rule is that if the profit-sharing plan qualifies as a tax-exempt trust under other sections of the bill (sec. 501 (e)), the contributions of the employer are deductible as a business expense in the year he pays them into the trust, if they also meet the test of reasonable compensation.

Section 403 also provides in subsection (a) (5) that if the plan is not one which qualifies as a tax-exempt trust, then the employer's contributions are deductible by him in the taxable year in which the contributions are distributed or otherwise made available to the employees as additional compensation.

Section 403 (a) (5) represents a change in the present rule of the Treasury Department. By a Treasury regulation announced November 2, 1948 (T. D. 5666), the Treasury ruled that contributions to a nonqualified profit-sharing plan are not deductible by employers in any year, unless there vests in each employee at the time the contributions are paid to the plan an absolute right to receive at some time in the future his share of such contributions.

Under the proposed bill this Treasury ruling is repealed for the future. All contributions to nonqualified plans will be deductible by employers in the years they are distributed to the employees, if they meet the test of reasonableness.

I am appearing here to request that the provisions of section 403 (a) (5) be made applicable to all taxable years ending in 1942 and thereafter. This will have the effect of overruling the 1948 regulation which the Treasury has applied to all taxable years back to 1942.

Since 1942, the Russell Manufacturing Co. has had in effect a plan of deferred compensation for certain executives and key employees. During the war, the company was extensively engaged in the production of war materials and, in 1942, it had entered into contracts for the production of such materials to the extent of several million dollars. It, therefore, became vitally necessary to make adequate provision for the retention of the company's key organization, and this necessity continued during the reconversion period following the conclusion of the war. This objective was accomplished by the plan for deferred compensation, based upon the company's net profit for each fiscal year ended November 30, the amount of which was placed in an irrevocable trust to be distributed as additional compensation to the respective beneficiaries over a 5-year period, provided they remained in the employ of the company. If any employee left the employ of the company, his undistributed portion was allocated to the other participants.

This extra compensation, therefore, although forfeitable under certain conditions by individual employees, was nonforfeitable by them as a group. It was expressly provided in the trust indenture that no part of the principal or income could ever revert to the company. The purpose of deferring the compensation as explained above was to induce these executives and key employees to remain in the employ of the company.

The company deducted the contributions paid to the irrevocable trust in its income-tax returns for the years in which the amounts were paid into the trust. This method was continued until 1949.

At the time our company's plan was adopted early in 1942, the contributions by the company to the plan were proper deductions. After the amendment of section 23 (p) in October 1942 until 1949, it continued to be the understanding of the company that these deductions were proper under section 23 (p) of the code (sec. 23 (p) (1) (D)).

However, on November 2, 1948, the Treasury amended its regulations under section 23 (p) by promulgating T. D. 5666 (sec. 29.23 (p)–11 of regulations 111, as amended by T. D. 5666). The amended regulation, which is still in force, provides: "If an amount is paid during the taxable year but the rights of the employee therein are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year."

The foregoing regulation was promulgated by the Treasury under section 23 (p) of the 1939 Internal Revenue Code, as amended by the Revenue Act of 1942. This 1948 regulation was the first notice the company had that the contributions to its plan might not be deductible in any taxable year. Prior to the promulgation of the amended regulation in 1948 the regulation had provided as follows with respect to a plan which did not qualify as a tax-exempt trust:

"If an amount is accrued but not paid during the taxable year, or if paid during the taxable year and the employees' rights are forfeitable at the time the amount is paid, no deduction will be allowed the employer for such amount for such taxable year."

You will observe that this earlier regulation speaks of the forfeitability of the employees' rights in the plural as if referring to the group of employees and not to each individual employee, and, further, this regulation did no more than deny a deduction to the employer in the year in which he paid his contributions into the plan or trust. Thus, under the earlier regulation, which was issued soon after section 23 (p) was amended in 1942, it was the understanding of the company that if its plan did not qualify as a tax-exempt trust under section 165, at least its contributions to the plan would become deductible in the later years in which they were distributed to the employees.

It was, therefore, only after operating under section 23 (p) as it was amended by the Revenue Act of 1942 for a period of some 6 years that this company became aware that it might not be entitled to deduct its contributions to its profit-sharing plan.

It is difficult for us to believe that Congress ever intended to deny the employer a deduction on account of these contributions even in the year the payments were received by and became taxable to the employees, so long, of course, as the additional payments to the employees satisfied the test of reasonable compensation.

The present Treasury regulation is particularly unreasonable because it discriminates against employers who set aside a percentage of their profits in an irrevocable trust. If this company had not used an irrevocable trust but had merely set aside annually a percentage of its profits to be distributed to certain of its key employees in future years, the payments would unquestionably have been deductible in the years of their distribution, subject only to the test of reasonableness. It is difficult to understand why funds placed in an irrevocable trust should not be similarly deductible when distributed. The trust serves only the purpose of guaranteeing to the employee-beneficiaries that the profits are available for distribution in the years they become entitled to them. It does not operate as a device for the avoidance of taxes by anyone.

If section 403 (a) (5) were made applicable to taxable years ending in 1942 and thereafter, the contributions of this company to the irrevocable trust would, without question, be deductible in the years the payments were distributed to the employees. Under section 403 (a) (5) that is the rule for the future. In view of the hardship and inequity of the present Treasury regulation, it is respectfully submitted that the provisions of section 403 (a) (5) should be made retroactive to the extent of overruling the Treasury regulation from the time section 23 (p) was amended by the Revenue Act of 1942. It would be a severe penalty to deprive this taxpayer entirely of deductions which represent reasonable compensation to its key employees for their efforts in improving the earnings of the company.

The application of section 403 (a) (5) to all taxable years ending in 1942 and thereafter would have a negligible effect upon the revenues. Obviously no taxpayer would have paid compensation into an irrevocable trust if it had known that no deduction would be allowed for those payments in any taxable year. So far as our company can determine, only a very few taxpayers were innocently trapped into a position where the possibility exists that reasonable compensation placed in trust for later distribution will be disallowed as a deduction in any year. Most taxpayers would not have established irrevocable trusts which were not part of a qualified plan of profit sharing. It was our eagerness to give an ironclad guaranty to certain of our officers and key personnel that nothing could deprive them of the additional compensation if they remained in the employ of the company, that led us to make the trust irrevocable. Had we realized that we were seriously jeopardizing or depriving the company of its right to deduct the additional compensation for tax purposes, it is obvious that other arrangements would have been made. Neither this taxpayer, which is a relatively small corporation, nor any other corporation can afford to distribute a substantial part of its profits as reasonable compensation without obtaining the benefit of a tax deduction therefor.

It is respectfully submitted that the application of section 403 (a) (5) to the taxable years 1942 and thereafter will have virtually no effect upon the revenues. In addition, it will correct an inequity which seriously affects the finances of this company and one which we believe the Congress did not intend.

The CHAIRMAN. Mr. Seligman.

Make yourself comfortable, Mr. Seligman and identify yourself for the reporter.

STATEMENT OF JOSEPH L. SELIGMAN, JR., ATTORNEY, PILLSBURY, MADISON & SUTRO

Mr. SELIGMAN. My name is Joseph L. Seligman, Jr., and I am associated with the law firm of Pillsbury, Madison & Sutro, in San Francisco, Calif.

The overall objectives which H. R. 8300 seeks to achieve are most desirable and as an attorney, I fully appreciate the magnitude of the undertaking. Those responsible for its drafting are to be congratulated on the large measure of success they have attained. Unfortunately, however, oversights and results not intended are inevitable.

The technical staffs are working hard to correct those that are called to their attention.

My purpose in appearing before you this morning is to focus attention upon three problems affecting employee benefit plans, which I believe to be of fundamental importance and widespread application. If existing plans are to continue to operate without unfair and unintended tax penalty, and if American industry is to be encouraged to develop new and better employment benefit plans, this committee should amend H. R. 8300 in the following three ways:

First, qualified health and accident plans should be able to provide benefits proportionate to length of service.

Second, such plans should not be required to provide a waiting period.

Third, qualified profit-sharing and stock-bonus plans should be permitted to allocate employer contributions in proportion to reasonable employee contributions and in recognition of other retirement income, such as social security.

My first point involves section 105 of H. R. 8300, which purports to encourage the adoption of employers' health and accident plans by providing a limited tax exclusion for the benefits paid under those plans which meet certain tests. These tests seem well enough suited to hospital and medical plans and other insured plans, but they do not apply fairly to the so-called salary continuation plans, under which the employer continues to pay full or half salary for a specified period during absence caused by sickness or accident.

Under many existing plans of this type—and there are lots of them—benefits increase with years of service. For instance a typical plan might allow an employee to accumulate 2 weeks of benefits during each of his first 5 years of employment and 3 weeks annually thereafter. Such a plan would not qualify under section 105, because the benefits accruing to the old and the new employee are not directly proportional to compensation. The tax laws should not penalize the sickness plan merely because it provides greater benefits to the long-service employee than to the newcomer. I am confident that this result was not intended and I am hopeful that this committee will revise section 105 to permit such plans to continue, without tax penalty, the very desirable practice of providing sickness benefits, which like annual vacation leave, increase with length of service.

My second point is also concerned with section 105 because of the proposed requirement that a sickness plan must provide a waiting period as a condition of qualification. Many existing salary continuation plans do not so provide. A sick or injured employee's salary is continued without reduction, until he returns to work, or until his accumulated benefits are exhausted. Assuredly this is socially desirable unless it is abused. Nevertheless overall policy considerations and protection of the revenues may suggest to you the advisability of some kind of a waiting period to deter malingering and to give the benefit of the limited tax exclusion only to those who are really sick—not to those who have a 1- or 2-day minor illness. These considerations however do not require a waiting period as a condition of qualification. On the contrary, I firmly believe that the revenues can be better protected and malingering more effectively discouraged by making a limited tax exclusion available only to benefits received for absence after a short initial period. Thus the benefits received during the first few days of absence would be fully taxable without regard to whether or not a plan has a waiting period. All benefits received for absence after this initial period would be exempt from tax, subject, of course, to the existing limits of section 105. In this way, all sickness plans would be treated the same for tax purposes while the employer would be left free to determine the desirability and duration of the waiting period.

My third point has to do with section 501 (e) (4) (B) which limits the permissible allocation of employer contributions under a qualified profit-sharing or stock-bonus plan. While this rigid mathematical formula permits the qualification of profit-sharing plans intended to provide incentive compensation, it does not allow the qualification of the many profit-sharing plans and thrift or savings plans designed to provide retirement income and promote employee savings. This is incongruous because these plans qualify today under the Internal Revenue Code, which H. R. 8300 is intended to liberalize.

There are many employers which for one reason or another cannot undertake the fixed obligation of a pension plan, but nevertheless want to provide a funded retirement program for their employees. A profit-sharing retirement plan is a very happy solution. Brokerage and advertising firms and many other relatively small employers often select this type of plan because their income may fluctuate substantially from year to year. Other employers use a profit-sharing retirement plan to supplement an existing pension or annuity plan. It is like adding a few shares of stock to the bonds you already own.

In many of these existing retirement plans, and in most thrift plans, each employee may elect one of several rates of contribution, and the employer's contributions are allocated proportionately. This would not be permitted under section 504 (e) (4) (B), although I am sure that the drafters did not intend to disqualify this type of plan. Frequently the allocation formula also—and I think quite properly—provides a higher rate of employer contributions for compensation in excess of some stated figure—usually $3,000 or $3,600—in order to take account of social security and other retirement income to which the participating employees will become entitled at retirement. The proposed law recognizes this for pension plans by permitting an employer to disregard up to the first $4,000 of compensation in the

allocation of employer contributions or benefits. There is no justification for denying similar treatment to a comparable retirement program funded by profit-sharing.

To correct this inequity, I strongly urge that an alternative provision be added to section 501 (e) (4) (B) which would permit the qualification of profit-sharing or stock bonus plans designed as retirement plans. Such an alternative statutory test should, at the very least, allow a plan formula to allocate employer contributions, not only in proportion to compensation, but also in proportion to reasonable employee contributions and in recognition of other retirement income.

I do not ask for a continuation of the present technical integration rules but I do ask that a profit-sharing plan, like a pension plan, should be able to disregard some stated amount of compensation, in order to provide each retiring employee with total retirement income, including social security, which will be fairly commensurate with his career compensation.

I want to thank this committee for affording me the opportunity to present my views. In the time allowed, it was impossible to discuss or even to summarize all the changes which I feel are necessary. Some are quite technical. Accordingly, I would like to file with this statement, a memorandum which discusses some of these changes in detail and offers suggested amendments in statutory language.

The CHAIRMAN. We are very glad to have that. We will put it in the record.

Thank you very much.

(Mr. Seligman's memorandum follows:)

MEMORANDUM CONCERNING TAX REVISION BILL (H. R. 8300) RELATING TO ACCIDENT AND HEALTH PLANS, PENSION, PROFIT-SHARING AND STOCK BONUS PLANS

By Joseph L. Seligman, Jr., Attorney, Pillsbury, Madison & Sutro, San Francisco, Calif.

As an attorney associated with the firm of Pillsbury, Madison & Sutro, of San Francisco, Calif., I am actively and almost continuously concerned with the legal implications of various types of employee benefit plans.

Most of the employers whom we represent on the west coast, both large and small, and indeed most employers in American industry today, have one or more plans designed to provide economic benefits to their employees and their beneficiaries to compensate in part at least for the loss of wages arising from sickness, accident, retirement and death. Congress has long recognized the overall social desirability of such plans and has fostered their growth by favorable tax legislation.

H. R. 8300 is intended to continue this trend by liberalizing applicable provisions of the Internal Revenue Code and by removing the uncertainty resulting from the delegation of considerable discretion to the Commissioner of Internal Revenue. It has been suggested by other witnesses that this commendable purpose has not been completely achieved. I would like to make clear at the outset that while there are many changes I would like to see this committee make in H. R. 8300, the only ones I am presently urging are those which I believe to be necessary to the continued operation of certain very desirable and widely used types of employee benefit plans. I am not asking for any more favorable tax treatment than we now have, but only that H. R. 8300 should not illogically and unintentionally penalize existing plans. In this connection please bear in mind that such plans grow with a company and become part of its very being. They are often incorporated in collective-bargaining agreements. Radical alterations cannot easily be made to comply with changing tax laws. Their continued successful operation is of the utmost concern to every affected employer and to his employees.

In preparing this memorandum I have first considered, as part A, the necessary revisions of H. R. 8300 pertaining to health and accident plans. In part B I have discussed the revisions pertaining to annuity, pension, profit-sharing and stock bonus plans and trusts and the distributions therefrom. In part C I have summarized the amendments of H. R. 8300 which I believe to be necessary.

PART A. RECOMMENDED AMENDMENTS TO EMPLOYERS' ACCIDENT AND SICKNESS PLANS, SECTIONS 104, 105, AND 106 OF H. R. 8300

A great many employers have plans which are designed to provide a continuation of income during absence from work due to nonindustrial injury or sickness. In a typical plan of this kind, all regular employees after 1 year of service are entitled to a continuation of earnings during such absence for a maximum period of 2 weeks. This maximum period of benefits accumulates during the first 4 years at the rate of an additional 2 weeks each year, and at the end of 5 years and thereafter it accumulates at the rate of 3 weeks per year, with a maximum accumulation of 26 weeks after 10 years of service.

When a covered employee is absent because of nonindustrial injury or sickness, he continues to receive his regular salary from his employer until he returns to work or uses up his accumulated maximum period of benefits to which he is then entitled. Such payments are made by the employer "out of the till" and the employer does not make any advance contributions to fund the plan. There is no separate fund from which plan benefits are thereafter paid.

I believe that it was the intent of the drafters of H. R. 8300 that a plan such as this should be treated as a "qualified employer's accident or health plan" within the meaning of section 105 of H. R. 8300. I respectfully submit that sections 104, 105, and 106 do not achieve the desired result. I strongly recommend that these sections be amended to clarify their intended meaning when applied to so-called salary continuation plans and to prevent unfair taxation of the employees receiving benefits under such plans.

(1) Section 104 should specifically exclude qualified health and accident plans

Section 104 (a) specifically exempts from gross income:

"(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, *to the extent such amounts are attributable to contributions by the employer* which were not includible in the gross income of the employee);" [Italics supplied.]

The italicized clause obviously refers to the exemption from gross income under section 106, which provides as follows:

"Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness."

The difficulty with sections 104 and 106 in their present form is that in a salary continuation plan the employer does not "contribute" to the plan, but rather pays benefits pursuant to the plan directly to entitled employees. If section 106 is interpreted literally, it would not apply to such plans and therefore the parenthetical clause in section 104 (a) (3) would not be applicable. It could then be argued that the amounts received by the employees are exempt from gross income under section 104 (a) (3) as the language there used was interpreted in *Epmeier* v. *United States* (199 F. (2d) 508 (7th C. A., 1952)).

Such an interpretation would, in my opinion, do violence to the plain and obvious intent of the drafters of sections 104, 105, and 106, and would continue and compound the confusion presently existing as to the correct interpretation of section 22 (b) (5) of the Internal Revenue Code. That these sections were not intended to require the employer to contribute to a separate fund is evident from the report of the Committee on Ways and Means to accompany H. R. 8300 (H. Rept. No. 1337, 83d Cong., 2d sess.) and especially the two examples set forth on page A-34 thereof.

Recommendation.—To correct the foregoing situation, section 104 (a) (3) should be amended to read as follows:

"(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee (*a*) *under a qualified employer's accident or health plan which is covered by section 105, or* (*b*) to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee); and" [Italics indicate suggested new material.]

(2) Section 105 Should Expressly Cover Unfunded Qualified Employers' Accident and Health Plans

Like sections 104 and 106, section 105 is also drafted in terms of plans to which the employer contributes. To avoid the problems discussed above and to make this section applicable to salary continuation plans, section 105 (b) (2) should be amended.

Recommendation.—Section 105 (b) (2) should be revised to read as follows:

"(2) *are provided by the employer or* are attributable to contributions of the employer which were not includible in the gross income of the employee," [Italics indicate suggested new material.]

(3) Section 105 Should Permit Sickness Benefits to Increase With Service

Section 105 (c) (1) (C) (iii), by incorporating the provisions of section 501 (e), requires that the benefits provided under a plan should "not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower" (section 501 (e) (4) (A)). Many salary continuation plans provide benefits which are graduated in terms of years of service. As indicated above, 2 weeks of benefits may be granted for each of the first 4 years of service. Thereafter, 3 weeks of benefits may be granted annually for all regular employees, regardless of salary. Such a plan formula, like comparable vacation plan formulas, is in very widespread use throughout American industry and achieves the desirable result of rewarding continued faithful service. There does not appear to be any reason why sickness and accident benefits, graduated on a nondiscriminatory basis, in terms of service, should disqualify an "employer's accident and health plan" under section 105.

Recommendation.—Section 105 (c) (1) (C) (iii) should be amended to read as follows:

"(iii) the benefits payable under the plan; except that for purposes of this subparagraph, *(1)* wages shall be taken into account without regard to the $4,000 exclusion contained in section 501 (e) (4) (A), and *(2) benefits graduated in terms of years of service shall not disqualify a plan otherwise meeting the requirements of this subsection (c)*; and" [Italics indicate suggested new material.]

(4) Section 105 should not require a waiting period as a condition of qualification

Section 105 (c) (1) (D) requires that a qualified plan must provide "a waiting period before the time when payments are to begin under the plan". It is appreciated that policy considerations may dictate some requirement to prevent malingering in minor illnesses and a consequent loss of revenue. It does not seem, however, that any such policy considerations require a waiting period as a condition precedent to the qualification of a sickness plan, especially such plans as are intended to provide a continuation of earnings during absence due to illness.

It is suggested that the policy considerations can be met by providing that the income paid from a qualified plan during a short initial period should be taxed to the recipient rather than disqualify the plan if it does not provide a waiting period. In other words, the policy objectives can be achieved by deleting the requirement of a waiting period in the definition of a "qualified employer's accident or health plan" and incorporating the waiting period provision in section 105 (b) which limits the exclusion that is provided by section 105 (a).

Recommendation.—Section 105 (c) (1) (D) should be deleted in its entirety and section 105 (b) (1) should be amended to read as follows:

"(1) are received as compensation for loss of wages *due to absence caused by personal injuries or sickness after the* ____ *day of any such absence*, and" [Italics indicates suggested new material.]

The number of days in the foregoing suggestion should be determined as a matter of congressional policy. It is suggested that it should be not less than 3 nor more than 8 days.

(5) Section 105 should permit two sickness and accident plans to operate concurrently

The sentence at the end of section 105 (c) (1) purports to include within the definition of "qualified employer's accident or health plan" those established pursuant to State law. In some States it is not necessary to have a separate fund; the plan can operate by direct payments "from the till". Again, some employers' plans are supplemental to the State plan. A literal interpretation of section 105 (c) (1) (C) (iii) would seem to indicate that each plan taken

separately must provide nondiscriminatory benefits, whereas it would seem more appropriate that if there is more than 1 plan operating at the same time, the benefits under the 2 plans could be combined for purposes of testing whether or not the plans are nondiscriminatory.

Recommendation.—Amend the last sentence of section 105 (c) (1) to read as follows: "For purposes of *this paragraph*, if the law of a State, a Territory, or the District of Columbia requires employers to make payments into a fund *or to provide benefits in accordance with the statutory formula*, such fun *or such benefits* shall be treated as a plan *or part of a plan* of an employer for the exclusive benefit of his employees." [Italics indicates suggested new material.]

PART B. RECOMMENDED AMENDMENTS TO PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS, SECTIONS 72, 401, 402, 403, 501 (E), 505, AND 2039

These sections, all of which pertain to employees' retirement plans, will not be discussed in numerical order, but rather will be considered first as they apply to the qualification of retirement plans, and then as they apply to the distributions from such plans.

(1) The formula regulating qualified pension and annuity plan contributions and benefits is too rigid—section 501 (e) (4) (A)

Section 501 (e) (4) (A), applicable to pension and annuity plans, provides that the "contributions or benefits of or on behalf of" an employee under the plan cannot exceed those for any lower paid participant, except that the first $4,000 of compensation can be disregarded. As drafted, this subparagraph takes no account of credited service. There are a number of qualified plans which, to reduce turnover, provide one rate of contributions or benefits for participants until they have a certain number of years of service or participation in the plan and thereafter the contributions or benefits of such participants are at a higher rate. There are other plans which, to induce employees to accept foreign service, provide a higher rate of benefits during such service. There are still others which, to reduce the impact of inflation, base benefits on average pay over the final 5 or 10 years.

Each of these types of plan is in accordance with sound pension principles and fills a definite business need. Each of them is permitted under present law, and there are a very large number of employees presently covered under these three types of qualified plans. The law should permit and foster annuity and pension plans which give recognition to long service or to foreign service by an increased rate of employer contributions or employee benefits based on such service, and those plans which use final average pay instead of total pay as a measure of benefits.

A second difficulty with this subparagraph (4) (A) is the requirement that the contributions or benefits for "any" covered employee must be tested against those for "any other" covered employee. It must be assumed that the use of the word "any" refers to any one employee. This requirement will work a severe hardship. In contributory plans where the employee has the right to elect one of several rates of contribution, which it turn determines the amount of the employer's contributions and the amount of the employee's benefits, the whole plan would seem to have to be geared to the lowest common denominator. No employee could receive a higher rate of contributions or benefits than the covered employee electing the lowest available rate.

Moreover, the requirement that the test be made on the basis of the individual employee is unfair and would be difficult to administer for large employers. Under existing law the Commissioner of Internal Revenue has tested for discrimination on the basis of groupings by salary classifications and, in the case of very large employers, on the basis of a sampling of each such selected group. We submit that this practice is equitable and administratively convenient and that any requirement that the contributions or benefits for each employee must be tested against those for every other lower paid employee is unfair in substance and extremely burdensome from a practical standpoint. It is not necessary to prevent discrimination, and it would delay rather than expedite the qualification of any plan in which the contribution or benefit was not directly and uniformly proportionate to the total career compensation as defined in section 501 (e) (4).

"*Recommendation.*—Delete the word "if" following the heading of section 501 (e) (4) and revise section 501 (e) (4) (A) to read as follows:

"(A) In the case of a pension or annuity plan, the contributions or benefits of or on behalf of the employees under the plan do not bear a higher ratio to

compensation for any *group of* covered employees than for any other *group of* covered employees whose compensation is lower, except that (*i*) the first $4,000 of annual compensation may be disregarded, (*ii*) *the rate of contributions or benefits under the plan may be increased in recognition of continued years of employment or years of participation in the plan or employment outside the United States, provided that the rate of contributions or benefits for any group of covered employees with the most years of employment or years of participation may not as a precentage of compensation be more than twice the rate of contributions or benefits of or on behalf of any group of covered employees having fewer years of employment or years of participation in the plan,* (*iii*) *the rate of employer contributions or benefits under the plan may be proportional to reasonable employee contributions, and* (*iv*) *total contributions or benefits may be based on total compensation or compensation for any period designated in the plan provided such period is not less than five years.*" [Italics indicates suggested new material.]

(*2*) *The formula regulating the allocation of employer contributions under qualified profit-sharing and stock bonus plans is too rigid—section 501* (*e*) (*4*) (*B*)

The comments and recommendations made above with respect to section 501 (e) (4) (A), pertaining to annuity and pension plans, are equally applicable to section 501 (e) (4) (B) pertaining to profit-sharing and stock bonus plans. Subparagraph (B) should therefore be revised to permit recognition of years of continued employment or continued participation in the plan, of place of employment, and to permit testing by groups instead of by individual employees.

In addition, and perhaps of even greater overall importance, is the use of the 75–25 percent and the 2 to 1 tests in subparagraph (B). These tests are admirably suited to plans primarily intended as incentive compensation plans in which management desires to retain some discretion to reward exceptional service. Such plans are highly desirable in our overall economic structure and should be permitted and fostered by legislation of the type incorporated in subparagraph (B).

Subparagraph (B), however, does not apply with fairness to those profit-sharing and stock bonus plans which are primarily designed to create or supplement retirement income. Many of these plans require employee contributions and usually the employee is given certain elective rates at which he can contribute. Thus, many profit-sharing and stock bonus plans and most of the so-called thrift plans or savings plans permit an employee to contribute any one of several stated percentages of his compensation to be matched in certain fixed proportions by the employer's contribution out of profits. In a straight matching plan if one employee should elect to contribute 2 percent and another elect to contribute 5 percent, the employer's contribution allocated to the second employee would be more than twice that allocated to the first employee and therefore would not qualify under section 501 (e) (4) (B).

Further, subparagraph (B) is deficient in that, unlike subparagraph (A), it does not permit stock bonus and profit-sharing plans intended as retirement plans to exclude some amount of compensation, such as the first $4,000, in the allocation formula or to allocate the employer's contributions at a higher rate on compensation received in excess of $4,000 than on the first $4,000. There are many employers who have no pension or annuity plan but who have qualified stock bonus or profit-sharing plans designed to provide adequate retirement income for their retiring employees. Many of these existing plans are integrated with social security under current regulations and rulings issued by the Commissioner of Internal Revenue. I know of no policy considerations indicating that this practice should be discontinued or prohibited. Quite the contrary, I believe that a well-designed stock bonus or profit-sharing plan should, in the absence of an integrated annuity or pension plan or one that is not fully integrated, take into account social security benefits if retirement income is the primary objective.

Recommendation.—Because there are so many alternative ways of taking care of the problems discussed above, no specific revision of or addition to section 501 (e) (4) (B) in terms of statutory language is being submitted. It is strongly urged, however, that the present language does not accomplish the announced congressional intent and should be substantially revised or expanded to cover the types of stock bonus and profit-sharing plans discussed above. Specifically, section 501 (e) (4) (B) should at the very least permit qualified profit-sharing and stock bonus plans to disregard up to the first $4,000 of par-

ticipants' compensation, to allocate employer contributions in proportion to employee contributions or length or place of service within reasonable limits, and to be tested by groups instead of by individual employees.

(3) The definition of parent company is too restrictive—sections 402 (a) (3) (A) (ii) and 505 (b) (1)

I understand that California Texas Oil Co., Ltd., is submitting a memorandum recommending (a) that the parenthetical reference in section 402 (a) (3) (A) (ii) of H. R. 8300 be changed from section 421 to section 505, and (b) that the phrase "more than 50 percent" in section 505 (b) (1) be changed to "50 percent or more." I believe that section 402 (a) (3) (A) (ii) should be changed as recommended by California Texas Oil Co., Ltd., for the reasons set forth in its memorandum. I further believe that the change in section 505 (b) (1) which it recommends is desirable, but I would like it to go even further so that the definition of parent corporation would include a corporation owning 10 percent or more of the stock of another corporation where all the stock of such latter corporation is owned by not more than five corporations.

Many of the oil, chemical and mining companies have formed exploration, experimental or operating companies which are owned by them jointly. Sometimes as many as five companies will acquire all the stock of a development or operating company in varying percentages. The pension, profit-sharing or stock bonus plan of the employer cannot invest in its own stock because all of that is owned by its parents. Under the revision of section 505 (b) (1) suggested by Caltex, such a plan could not invest in the securities of any of its parent companies because no one of them owns "50 percent or more" of the stock of the development or operating company. It is desirable from both a business and an equitable point of view that such employers should be able to adopt pension, profit-sharing or stock bonus plans in which embployer and/or employee contributions may be invested in proportional dollar amounts in the issued securities of the parent companies.

Recommendations.—(a) In section 402 (a) (3) (A) (ii) change the parenthetical reference from section 421 to section 505.

(b) Amend section 505 (b) (1) so that the definition of "parent corporation" includes any corporation which owns 10 percent or more of the stock of the employer corporation where all the stock of such employer corporation is owned by not more than five corporations.

(4) Section 403 (a) (3) (B) needs minor technical revision

Section 403 (a) (3) (B) of H. R. 8300 permits an affiliated group of corporations, in which some of the corporations have losses, to maintain a qualified profit-sharing plan for the employees of the affiliated group. There was some question under section 23 (p) of the Internal Revenue Code as to whether this was permissible. The addition of this new section is therefore most desirable. There are, however, two technical changes which we recommend in order to clarify the intended meaning of this new subparagraph (B) and to avoid unnecessary administrative work.

First there are in existence plans which are in substance typical profit-sharing plans but in which all of the employer and employee contributions must be invested in the common stock of the employer. Such plans meet the requirements of section 165 (a) of the Internal Revenue Code, but it is not clear whether they are properly classifiable as a profit-sharing plan or a stock bonus plan.

Subsection 403 (a) (3) is entitled "Stock bonus and profit-sharing plans," but subparagraph (B) thereof refers only to a "profit-sharing plan." I know of no reason why the policy considerations applicable to profit-sharing plans in this regard are not equally applicable to stock bonus plans. I believe that it is desirable in the interest of clear statutory construction to avoid a possible negative inference and to include stock bonus plans within the purview of this subparagraph (B).

Secondly, section 403 (a) (3) (B) permits the profit companies in an affiliated group to make the contributions which would be required of the loss companies and requires that such contributions by the profit companies be proportional to their share of the adjusted total current and accumulated earnings or profits of the affiliated group. As a practical matter, it is often exceedingly difficult, within the time allowed, to compute the earnings of each member of an affiliated group properly adjusted for tax purposes and further adjusted as provided in this subparagraph (B). There would seem to be no valid reason to require such proportional contributions by the profit members of the affiliated group where a consolidated return is filed. In this case it would be in the best interests of all

concerned to permit the employers to allocate the contribution of the affiliated group among the members thereof in such proportion as they wish or to attribute the entire contribution on behalf of the loss companies to the parent company.

Recommendation.—Amend section 403 (a) (3) (B) to read as follows:

"(B) *Stock bonus or* profit-sharing plan of affiliated group.—In the case of a *stock bonus or* profit-sharing plan of a group of corporations which is an affiliated group within the meaning of section 1502 if any member of such affiliated group is prevented from making a contribution which it would otherwise have made under the plan, by reason of having no current or accumulated earnings or profits or because such earnings or profits are less than the contributions which it would otherwise have made, then so much of the contribution which such member was so prevented from making may be made, for the benefit of the employees of such member, by the other members of the group, to the extent of *current and*[1] accumulated earnings or profits, except that, *unless a consolidated return is filed by such affiliated group as provided in chapter 6 of this subtitle,* such contribution by each such other member shall be limited to that proportion of its total current and accumulated earnings or profits remaining after adjustment for its contribution deductible without regard to this subparagraph which the total prevented contribution bears to the total current and accumulated earnings or profits of all the members of the group remaining after adjustment for all contributions deductible without regard to this subparagraph. Contributions made under the preceding sentence shall be deductible under subparagraph (A) of this paragraph by the employer making such contribution, and, for the purpose of determining amounts which may be carried forward and deducted under the second sentence of subparagraph (A) of this paragraph in succeeding taxable years, shall be deemed to have be made by the employer on behalf of whose employees such contributions were made." [Italics indicates suggested new material.]

(5) Continued qualification of existing plans and trusts—section 403 (c)

Section 403 (c) purports to permit existing stock bonus, pension or profit-sharing trusts and annuity plans that are currently qualified under section 165 (a) of the Internal Revenue Code to continue as qualified plans subject to the limitations imposed by sections 503, 504, and 505 of H. R. 8300. But if a plan which is presently qualified under section 165 (a) of the Internal Revenue Code is amended after H. R. 8300 is enacted, will the qualification of the amended plan be tested under section 165 (a) and the Treasury regulations and rulings issued pursuant thereto, or will it be tested under section 501 (e) of H. R. 8300?

It is self-evident that the principles of sound draftsmanship require the inclusion in section 403 (c) of some express statement covering this problem. If section 165 (a) of the Internal Revenue Code is to continue to be applicable to existing qualified plans which are amended after the enactment of H. R. 8300, the result will be to have the two statutory tests—the old and the new—running side by side indefinitely into the future. Inasmuch as the old and the new tests are by no means identical, this may well lead to considerable confusion and uncertainty, especially where far-reaching amendments of existing qualified plans are concerned. Such amendments would pose very serious questions as to whether the old plan was being amended or whether a new plan was in fact being substituted under the guise of an amendment. On the other hand, if the continued qualification of an existing qualified plan which is amended after the enactment of H. R. 8300 is to be tested against the new standards, then difficulty will arise in the case of very minor amendments of existing qualified plans which do not meet the new standards.

Recommendation.—It is recommended that section 403 (c) be amended so that the new standards will be applicable to existing qualified plans only where an amendment adopted after the enactment of H. R. 8300 materially affects the employees covered or the benefits provided by the plan, and even this limited category should be restricted to exclude any changes made in the benefit formulas of existing plans to compensate for changes in the Federal social security laws or in the laws of any State requiring an employer to contribute to or provide comparable benefits under a State plan.

(6) Taxation of employees' annuities and beneficiaries of employees' trusts—sections 401 and 402

Sections 401 and 402 prescribe the tax treatment of distributions by or under a plan or trust described in section 501 (e). There is nothing in either of these

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[1] These two words were apparently omitted inadvertently.

sections which accords the same treatment or, indeed, any prescribed tax treatment to distributions by or under plans or trusts which are qualified under section 165 (a) of the Internal Revenue Code and which continue to be qualified as tax exempt under section 501 (a) of H. R. 8300 by reason of the provisions of section 403 (c) of the bill. In the case of a plan or trust which is currently qualified under section 165 (a) of the code but which will not be able to meet the new mathematical tests of section 501 (e) of H. R. 8300, distributions by such a plan or trust will not be covered by sections 401 or 402 of the proposed law because it will not be a plan or trust described in section 501 (e).

If this conclusion is sound, it follows that the employees (and their beneficiaries) participating in a trust that is presently qualified under section 165 (a) of the Internal Revenue Code but which cannot qualify under section 501 (e) of H. R. 8300 will not be entitled to the liberalized capital gains treatment provided by section 402 (a) (2), and what is even more unfair, they will not even be entitled to the capital gains treatment which they now enjoy. I do not believe that this result was intended by those who drafted H. R. 8300 and, if it was intended, the result is exceedingly harsh and inequitable and renders the saving provisions of section 403 (c) of little practical value.

In the time available for the preparation of this memorandum it has been impossible to determine all of the other places in which this same result may occur. One place that has been noted is in section 2039 but, inasmuch as I am, in a later part of this memorandum, recommending that the policy decision incorporated in sections 72 and 2039 be reversed, I am not making any specific recommendation with respect to section 2039 in connection with the point here under discussion.

Recommendations.—(*a*) Section 401 (b) (1) (A) should be amended to read as follows:

"(A) an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 501 (e) (3) and (4) *or section 403 (c)*;" [Italics indicates suggested new material.]

(*b*) Amend the phrase "described in section 501 (e)" wherever it appears in section 402 (a) (1), (2) and (4) to read "described in section 501 (e) *or section 403 (c)*". [Italics indicates suggested new material.]

(*c*) Amend H. R. 8300 wherever else necessary in order to provide the same tax treatment to the participants and beneficiaries of existing plans and trusts which continue to be qualified by reason of section 403 (c) as is granted by H. R. 8300 to participants and beneficiaries under plans and trusts which meet the requirements of section 501 (e).

(7) *The proposed taxation of joint and survivor annuities provided by qualified plans or trusts is unfair as a matter of tax policy—sections 72 and 2039*

Sections 72 and 2039 of H. R. 8300 propose significant changes in the rules governing the imposition of income and estate taxes on survivorship annuities provided under qualified employees' retirement plans. Aside from replacing the so-called 3-percent rule with a new concept in taxing installment proceeds received under annuity contracts, the effect of these changes, so far as they cover survivorship annuities, may be summed up by stating that section 72 effects an increase in income taxes for a large class of taxpayers, and section 2039 effects a decrease of estate taxes for a relatively small number of estates.

Under present law, with few exceptions, the whole value of a survivorship annuity is includible in the estate of a deceased employee without distinction as to whether any particular portion of such value is attributable to investment in the annuity contract by the employee or his employer. The proposed legislation would exclude from the taxable estate of the decedent so much of the value as is attributable to his employer's contributions under a qualified pension trust, annuity, profit-sharing or stock bonus plan. This will remove a burdensome feature of the present law which reduces the net value of the benefits provided under a qualified retirement plan in situations where the deceased employee's estate is sufficient to incur estate taxes. However, since the estate of the average employee will not exceed the estate tax exemptions granted by law, relatively few estates will get the benefit of the proposed estate tax relief.

As a condition of granting this estate tax relief, reciprocal changes in income taxes are being proposed which will bring about added taxes in every case. Where estate taxes are reduced by exclusion from the taxable estate of values attributable to employer contributions, an addition to income taxes may be justified. But where no estate tax benefit can be derived by such exclusion adding to

the income tax burden of the surviving beneficiary seems entirely out of harmony with the general philosophy of tax reduction expressed by H. R. 8300.

It is suggested that as a matter of overall policy the present estate and income-tax treatment of the survivor feature of joint and survivor annuities provided under qualified employees' retirement plans should be continued.

Recommendations.—(*a*) Amend section 2039 of H. R. 8300 so that the value at the date of the annuitant's death of the survivor's interest in a joint and survivor annuity contract provided under a retirement plan or pension, profit-sharing or stock bonus trust which is exempt under section 501 (a) by reason of section 501 (e) or section 403 (c) will be includible in the gross estate of the decedent for Federal estate tax purposes.

(*b*) Amend section 72 of H. R 8300 so that the value includible under section 2039 will be treated as the survivor's investment in the contract for purposes of determining the amount of the payments which are thereafter properly excludible from the survivor's gross income.

(8) *Other provisions applicable to pension, profit-sharing and stock bonus plans and trusts*

There are substantial defects in other provisions of H. R. 8300 relating to pension, profit-sharing and stock bonus plans and trusts. For instance, objections might well be raised to some of the provisions of section 501 (e) (3) relating to the permitted classification of employees in a qualified plan, to section 503 describing prohibited transactions in the case of qualified trusts, to section 505 which sets forth rigid rules as to the allowable investments of qualified trusts, to sections 511–514 relating to the taxation of so-called unrelated income of qualified trusts, and to section 6033 requiring the filing of certain unnecessary annual returns.

Since these points are being adequately covered by others, no purpose would be served by repeating them in this memorandum.

PART C. SUMMARY OF RECOMMENDED REVISIONS OF H. R. 8300

1. Amend section 104 (a) (3) to exclude qualified employer's accident and health plans.
2. Amend section 105 (b) (2) to cover unfunded qualified employer's accident and health plans
3. Amend section 105 (c) (1) (C) (iii) to permit sickness benefits to increase with length of service.
4. Delete section 105 (c) (1) (D) and amend section 105 (b) (1) to remove the requirement of a waiting period as a condition of qualification of a sickness plan.
5. Amend section 105 (c) (1) to permit benefits under two sickness plans to be combined for testing purposes.
6. Amend section 501 (e) (4) (A) to permit qualified pension and annuity plan contributions and benefits to give recognition to years and place of service, employee contributions, average final pay, and to allow testing by groups of employees.
7. Amend section 501 (e) (4) (B) to permit qualified profit-sharing and stock bonus plans to allocate employer contributions proportionately to employee contributions and to take account of social security and other retirement income and to be tested by groups instead of individual employees.
8. Amend section 402 (a) (3) (A) (ii) to change the reference to section 505 instead of section 421.
9. Amend section 505 (b) (1) to expand the definition of parent company.
10. Amend section 403 (a) (3) (B) to cover stock bonus plans and to remove the requirement of proration if a consolidated return is filed.
11. Amend section 403 (c) to permit amendments of existing qualified plans.
12. Amend sections 401 (b) (1) (A) and 402 (a) to cover distributions by existing plans which continue to qualify under section 403 (c).
13. Amend sections 72 and 2039 to continue the existing tax treatment of joint and survivor annuities provided by qualified employees' retirement plans.
14. Make necessary revisions of section 501 (e) (3), 503, 505, 511–514 and 6033.

The CHAIRMAN. Mr. Berglund.

STATEMENT OF CARL H. BERGLUND, CERTIFIED PUBLIC ACCOUNTANT, TACOMA, WASH.

Mr. BERGLUND. With your permission, I would rather stand, sir. I talk better on my feet. I am a little nervous. I think it is due to stage fright more than anything else.

The CHAIRMAN. Don't be nervous or stage-frightened.

Mr. BERGLUND. My name is Carl H. Berglund. I am a practicing certified public accountant from Tacoma, Wash. The client I represent is a firm known as the North Pacific Plywood, Inc., of Tacoma, Wash.

I want the committee to know that I not only speak for them, but the problem involves 20 such similar plants in the three Western States of California, Oregon, and Washington, and the combined number of workers are about 5,000.

In addition to the complete statement submitted for the record with your permission, we have a proposed change to the drafted Internal Revenue Act which involves sections 521 and 522, which I would also like to submit.

The CHAIRMAN. We will be glad to put it in the record.

The prepared statement and the proposed amendment follow:)

BEFORE THE FINANCE COMMITTEE OF THE SENATE OF THE UNITED STATES

A DISCUSSION OF THE TAX PROBLEMS CONTROLLING MANUFACTURING COOPERATIVES—PRESENTED BY CARL H. BERGLUND, CPA, TACOMA 2, WASH.

Mr. Chairman, gentlemen, the situation with which I wish to acquaint you concerns a type of organization which is entirely worker-owned. This type of organization is sometimes known as an industrial or manufacturing cooperative, although it pays corporate income taxes at the same rates as any other business corporation.

I shall confine my remarks to a particular type of manufacturing cooperative which manufactures plywood doors and furniture. These plywood cooperatives are located on the Pacific coast in Washington, Oregon, and California. Some 20 different plants are involved and the worker-owners number approximately 5,000. These plants produce approximately 25 percent of the Douglas fir and allied plywood produced in the Pacific Northwest. The plants are a substantial part of the business community in the three States and the worker-owners and their families are respected factors in the daily life of many local communities in the area.

It is a matter of considerable interest that the first Douglas fir plywood mill was a worker-owned mill, Olympia Veneer Co., organized in the State of Washington in 1921. This was the prototype for all similar mills since organized.

Historically, because a plywood mill may require from 150 to 400 skilled and semiskilled workers, it has been the practice for a sizable group of such workers to band together, purchase usually equal stock interests of from $1,000 to $5,000, and either build and equip or purchase a plywood mill. Thereafter, the mill is operated by the new company and most if not all of the production, maintenance, and supervisory employees in the mill are stockholders in it. Each stockholder feels and acts as an intensely interested owner as he performs his daily work in the mill. As a result of the cooperation of all such workers, practically all of whom in each mill receive the same hourly rate of pay, the worker-owned mills lead the other segment of the industry in man-hour production and in other phases of production and are free from work stoppages traceable to management-labor difficulties. Management salaries and overhead are also held to a minimum.

Our particular problem today stems from the fact that, as corporations, we are taxed just like any other corporation—large or small. In the determination of our net income, we are permitted, like any other corporation, a deduction for

salaries and wages in a reasonable amount. What is "reasonable" is a matter of opinion and, the Treasury Department's opinion is different to a considerable degree from the opinions of the various worker-owned plants.

For many years the Treasury Department has tacitly recognized the right of the worker-owned plants to pay their worker-owners substantially more hourly pay for their labor than nonowners employed in the same or other plywood mills. Deduction of this higher scale by the worker-owned plant was permitted as a "reasonable" expense of operation. Relying on this policy of tacit approval such worker-owned plants, in some instances, have paid their worker-owners at a straight time rate of as high as $3.50 per hour when the average hourly scale paid in the industry to noninterested, nonowner employees was $2.08 or $2.09. When it is remembered that practically all the worker-owners in a plant would receive the same rate of higher pay, it will be appreciated that the payment of such a differential could well amount to a huge sum of money in the 3-year period between payment by the worker-owned plant and the audit of its corporate income-tax return by Treasury Department agents.

Recently the Treasury Department's attitude with respect to these worker-owned plants has changed. The question of what is "reasonable" compensation for worker-owners seems to have become a very vital issue with the Treasury Department. Without going into the possible reasons for this changed attitude, suffice it to say that the client I represent and many other similar mills are in a serious predicament. My client has a net worth of approximately $750,000. The Treasury Department now proposes an adjustment to the mill's tax returns for the years 1950, 1951, and 1952 which will result in a minimum deficiency of $500,000 plus interest at 6 percent, on the basis that it is not "reasonable" to pay a fair differential to stockholder-employees. The potential deficiency will be more if excess profits taxes are involved. It can readily be seen that if the Treasury Department is successful in its attempt to redetermine our net income, that the Government will wind up by owning a plywood plant, and some 2[illegible]0 workers will have their life savings confiscated through taxation. In another worker-owned plant with which I am familiar, the Government very recently proposed a tax deficiency of approximately $800,000 for only 1 taxable year. This matter was settled in conference for $138,000, but the settlement seriously depletes the value of the worker-owners' interest in their mill and furnishes no basis for payment of even the settlement hourly rate in any subsequent year.

This problem of reasonable compensation cannot be settled with the Treasury Department because of the human factor involved. For instance, in our own case, we proposed a settlement with the Internal Revenue Service based on the settlement mentioned before, the one where $800,000 of tax was settled for $138,000. However, we are before a different conferee or group chief with different human traits and philosophies. Whether he has instructions from his superiors or not is not known, but the Internal Revenue Service's attitude as exemplified in the statements of the group chief is that they are now unwilling to use the previous settlement, just recently worked out, as a yardstick in future settlements, although our workers work just as industriously and efficiently under the same relative conditions. In mentioning what our problem is before the Treasury Department, I want it definitely known that we are not quarreling with the Department in any manner. They have a job to do under the present laws and are attempting to do it in the best manner which they know how. The Department had adopted a policy of selling tax cases, which in many instances proves highly satisfactory. However, in our present predicament, we want to know what we are getting for our tax dollar when we settle. It does look like reasonable compensation as determined in settlement negotiations is going to hinge on which worker-owned plant has the best representation or horse trader.

If we arrive at a settlement and settle this proposed deficiency for something that we can afford to pay and, therefore, is believed to be reasonable, what assurance have we that we can use this settlement in determining reasonable compensation to ourselves for future years? What assurance have we that other plants will receive the same consideration (no more and no less) than we did or that their income tax returns will be examined at all? The only answer to the whole problem is legislation.

Previous Congresses have seen fit to recognize the necessity for special tax treatment of cooperative associations. Section 101 of the present Internal Revenue Code (secs. 521 and 522 of the new code) was enacted into law with the Revenue Act of 1913 (sec. II, G). No substantial changes were made in this law affecting farmers' cooperatives until the Revenue Act of 1951, when cooperative associations were subject to normal and surtax but not excess profits tax, except

that deductions were to be allowed for dividends paid on capital stock, amounts allocated to patrons with respect to income not derived from patronage, and patronage dividends.

What we propose to the Congress is that code section 521 of the new code be extended to include all manufacturing cooperatives, regardless of their business or corporate form of organization or whether they issue capital stock or other certificates or evidences of membership. We do not seek carte blanche. We believe the plant must be one in which the members or stockholders are employed in the mill in sufficient numbers at the same hourly wage rate to insure that they actually cooperate as worker-owners. Then section 522 of the new code should be amended to permit deductions from net income of such organizations whatever amounts are paid to its worker-owners by way of wages for labor performed.

In the enactment of any law, we deal with the needs of the human individual, his philosophies, his ambitions and hopes. If it is right for farmers' marketing cooperatives to be exempt from taxation to a degree, is it not also right for a group of individuals who are attempting to accomplish a greater return for their product (which in this case is labor in a mill rather than on farms) to have the same tax advantage? A farmer's profit stems from the value of his crop. His crop increases in value according to the work and effort he puts into it to bring it to the consumer. The wage earner's profit is his wage into which he puts his labor. He owns no crop, no farmland—only an interest in a factory which is designed to produce a desirable product from raw materials through the expending of the individual effort of each worker-owner.

It may be of interest to illustrate just how a particular worker-owner plant gets started. Take the case of my client, North Pacific Plywood, Inc. In August of 1949, the Oregon-Washington Plywood Co., a regular capital stock company, which had been in business in Tacoma, Wash., for many years, manufacturing Douglas fir plywood, decided to go out of business and to dismantle its plant. It employed some 250 workers. What a blow—to be suddenly deprived of your only source of livelihood. Many of the workers had been with this company from 10 to 25 years. Fortunately, there were some resourceful workers among them. They had courage—good, old-fashioned American courage and ingenuity. A very small group organized a meeting to discuss ways and means of getting organized to continue the operation on a cooperative effort.

Consequently, it was decided to organize a corporation under the cooperative laws of the State of Washington. Each shareholder was required to own 2 shares at the outset, paying for one in cash and the other by deduction from wages over a fairly long period of time. Price of each share was $1,000. This group of workers successfully negotiated with their former employer for the purchase of the plant for $400,000, paying $150,000 down and the balance in installments. At the time of purchase, the cooperative had absolutely no timber prospects, being forced to buy its logs on the open market. This situation was one of the factors which contributed to the decision of the Oregon-Washington Plywood Co. to discontinue operations.

The going was tough the first year. Wages were only $1.60 per hour, being less than the average hourly wage paid in non-worker-owned mills. In 1950 conditions were better. The average wage paid to worker-shareholders was $2.84 which included overtime compensation at time and one-half, which they were required by Federal law to pay, being employers of their own services. In 1951 wage scale averaged $3.34, and in 1952 $3.012 per hour, with the same premium included for overtime compensation.

The hourly compensation in non-worker-owned plants for the present period is approximately $2.019 per hour. Production per man in such other mills is approximately 84.58 feet on a ⅜-inch thickness basis per man-hour. Production in worker-owned plants varies between 103 feet and 130 feet per man-hour depending upon the type of plant and the variety of product produced and whether logs are purchased on the open market or from plant-owned timber stands.

In considering the worth of a worker-shareholder's wages, consideration must be given to utilization of raw materials, minimum overhead, and administrative costs.

Who is to say that the worth of a stockholder is no more than the man who has no other interest in his job than his current pay checks? The board of trustees in a shareholder plant is elected from the membership, and make no mistake about it—the board is very sensitive to the opinions of the membership at large, and no important decisions are made that do not reflect the consensus of the shareholders.

In determining a reasonable amount as wages in these stockholder-owned plants, the Government seeks to have each year stand without respect to any other year. This may be good for raising tax revenue, but decidedly uneconomic and unfair to the plants and their stockholders. The Revenue Act of 1939 added section 122 (a) to the Internal Revenue Code, permitting adjusting profits and losses, taxwise, over a period of years rather than requiring an economic loss in any particular year to result in a tax penalty by not being able to offset losses against gains of other years This section of the code permits losses to be carried back for 1 year and forward for 5 years; a 7-year period over which profits and losses may be equalized for tax purposes. The draft Internal Revenue Act under consideration proposes the extension of the carryback provision to 2 years instead of 1, thus making the period over which profits and losses may be equalized, 8 years instead of 7 as at present. This philosophy should also be applied when considering reasonable compensation. For, after all, what is a cooperative member trying to accomplish but his own security? I do not know of a single case of a shareholder of a cooperative ever drawing unemployment insurance, although the corporation is required to pay 3 percent State and Federal unemployment taxes.

All isn't gold that glitters And wages in cooperative plants are not exactly what they appear to be on the surface, notwithstanding magazine articles and other uninformed opinion, to the contrary. The plywood industry is at present in a very serious economic slump. Orders are lagging far behind production. The worker in a non-worker-owned plant continues to draw his wages, provided he works. The cooperative plywood worker has his investment to protect. He continues to work but, in order to do so he must either pay himself wages out of previous profits, or cut his wages. It is this ability of the independent cooperative worker to adjust his wages to economic reality that makes his position different.

If there is any argument in favor of a guaranteed annual wage which many union organizations are advocating, there is equal argument in favor of a man (or woman) making his own economic security. This type of worker-owned enterprise actually holds out to the individual worker a chance to determine his place in the American business community by his own labor and initiative. Such resourcefulness on the part of the working man should be encouraged by the Congress, not doomed to bankruptcy and failure by the very tax laws under which a worker-owned mill pays its corporate income tax.

PROPOSED CHANGES COVERING MANUFACTURING COOPERATIVES—SUBMITTED BY CARL H. BERGLUND

The following is a proposed redraft of part III of subchapter F of chapter 1 of the Internal Revenue Code of 1954 (H. R. 8300). The italic indicates additional language added to the bill as passed by the House.

PART III—FARMERS' COOPERATIVES

Section 521 Exemption of Farmers' *and Manufacturing* Cooperatives from Tax.
Section 522. Tax on Farmers' *and Manufacturing* Cooperatives.

Section 521. Exemption of Farmers' *and Manufacturing* Cooperatives from Tax.

(a) EXEMPTION FROM TAX.—[a] Farmers' *and manufacturing* cooperative organization*s* described in subsection (b) (1) shall be exempt from taxation under this subtitle except as otherwise provided in section 522. Notwithstanding section 522, such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

(b) APPLICABLE RULES.—

(1) EXEMPT FARMERS' COOPERATIVES.—

(A) Exempt farmers' cooperatives.—The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis, A—for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the

value of the products furnished by them, or B—for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(B) Organizations having capital stock.—Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock is issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(C) Organizations maintaining reserve.—Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(D) Transactions with nonmembers.—Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(E) Business for the United States.—Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

(2) Exempt manufacturing cooperatives.—The manufacturing cooperatives exempt from taxation to the extent provided in subsection (a) shall be manufacturing associations, regardless of the business or corporate form of their organization, and whether they issue capital stock or other certificates or evidences of membership, in which:

(A) At least 80 percent of the members or stockholders are employed in production, maintenance, and supervisory capacities,

(B) At least 80 percent of the production, maintenance, and supervisory employees are members or stockholders, and

(C) At least 95 percent of the member or stockholder employees receive the same hourly wage.

SECTION 522. TAX ON FARMERS' *AND MANUFACTURING* COOPERATIVES.

(a) Imposition of Tax.—An organization exempt from taxation under section 521 shall be subject to the taxes imposed by section 11 or section 1201.

(b) Computation of Taxable Income For Farmers' Cooperatives.

(1) General Rule.—In computing the taxable income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under this chapter)—

(A) Amounts paid as dividends during the taxable year on its capital stock, and

(B) Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving-fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that disclosed to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

(2) Patronage Dividends, etc.—Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving-fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of

such dividend, refund, or rebate) shall be taken into account in computing taxable income in the same manner as in the case of a cooperative organization not exempt under section 521. Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the 9th month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates are attributable to patronage occurring before the close of such year.

(c) Computation of taxable income for manufacturing cooperatives.—In computing the taxable income of such an organization there shall be allowed as deduction from gross income (in addition to other deductions allowable under this chapter) all hourly wages paid to members or stockholders employed in production, maintenance, or supervisory work.

Mr. BERGLUND. I believe that the type of organization which I represent—and I have discussed this problem previously with Mr. Stam of the joint committee—is unique, in that all of the workers are shareholders in the company. Each owns a proportionate interest, and none owns more stock than his fellow employee, and they all have just one vote.

The board of trustees, as we call them in a cooperative, under the laws of the State of Washington, are elected from the membership and they decide the policies of the organization.

Our problem stems from the fact that, although we are cooperatives, true cooperatives, we are taxed in the same manner as any other corporation, just like United States Steel, for example. We pay normal surtax corporate rates and excess-profits taxes, where indicated.

For many years, these types of organizations have paid higher wages than prevailing wages paid noncooperative workers in the same industry. This situation has prevailed since 1921, when the first plywood cooperator was formed in Olympia, Wash. There has never been a problem on this until about 1931, when the only case settled in court was one known as Olympia Veneer, in which the taxpayer came out on top.

Recently, however, the Government has decided to challenge the reasonableness of wages paid to worker shareholders in these cooperative plants.

Now, what is reasonable to one man may be unreasonable to another. The human factor involved here is such that we can't determine with any assurance just what the Government's attitude is going to be from year to year as to what we can deduct as compensation.

The particular problem, for my particular client—I want to point out the seriousness of our problem. We have been recently examined by the revenue agents for the calendar years ending 1951 and 1952. We have a net worth of approximately three-quarters of a million dollars, and the proposed minimum tax deficiency is over one-half million dollars. That is why I am here and that is why I beg the committee's indulgence to hear me out in the brief time I have been allotted.

For an interesting but economically unrealistic portrayal of the situation that exists in the plywood industry, I would recommend to the committee an article in the Saturday Evening Post of April 5, 1954. It makes very interesting reading, but only gives one side of the problem.

The CHAIRMAN. What is the problem?

Mr. BERGLUND. The problem is that as long as we have human action, my idea of what is reasonable, and your idea of what is reason-

able, or the Treasury Department's in this instance, is always going to be different, and being cooperators we are not exempt under farmers' and manufacturing cooperatives. We do not want the same exemption they have. We are willing to pay taxes before dividends. We are not asking that dividends be deducted in computing our normal or surtax net income. But we want the Treasury Department to—and I think they would be perfectly happy to have this thing settled for them by legislation. I was an internal revenue agent at one time, and I just don't know what the answer would be if I were on the other side of the fence either.

The question seems to revolve around how long is a piece of string? What is reasonable?

The CHAIRMAN. You haven't told me, yet, what is the problem.

Mr. BERGLUND. The problem is that they have cut back the amount of wages which we can deduct in these years, 1950, 1951, and 1952, to a slight percentage over what the union mills are paying in the area, without giving any credit to the part that our workers play in the efficiency of the management and the conservation of raw materials and the minimum overhead, which applies in organizations of this type.

There is just no yardstick for a reasonableness in a situation like this, and in all these years, Mr. Chairman, we have relied upon this tacit policy, shall we say, of the Treasury Department—and if it seems like I am quarreling with the Treasury Department, it isn't so. I want to repeat what I said before, that if I were on the Treasury Department's side of the fence, I wouldn't know what to do with this problem, either. And I think they would be happy if we could get some legislation which would solve this particular problem for them.

The CHAIRMAN. How do you think it ought to be done?

Mr. BERGLUND. By amending sections 521 and 522 to include—521 should be amended to include "and manufacturing cooperative organizations"; 522 should be amended, also, to include a "deduction for wages." When I say "deduction for wages," these wages are determined by the board of trustees, acting in good faith, like the trustees of United States Steel or any other corporation would do, determining what is reasonable compensation.

I might point out that for the year 1950 we paid the United States Government $121,000 in income tax, which was roughly half of our income for the year. We are not trying to seek complete exemption from taxation. We are only trying to help the Treasury Department and help ourselves in what we feel is a mutual problem here in trying to escape from determining what is reasonable and just, allowing us what we can pay ourselves for wages.

I had hoped that the committee would have had a great many questions to ask me about cooperator plywood plants, but I did present a formal brief, as I mentioned. But cold words don't sometimes give the urgency of our problem.

If you, Senator, are ever out in the Northwest, I want to give you a personal invitation to call on me and I will take you through some of our mills, and even through our forest stands, and show you how plywood is made.

The CHAIRMAN. I think I probably read that story. What else?

Mr. BERGLUND. That is about all I want to say, and I want to thank you again for letting me appear before you. I hope I haven't talked in circles. I am not Don Quixote jostling with windmills.

I had hoped I could go back with some degree of confidence and tell these fellows their plants are not going to have to be turned over to the United States Government on Monday morning, and I think they would be happy, too. That is what we are faced with.

I might say before I left, the banker for my client and the banker for three other cooperative mills said, "You get your tax problems settled and we will talk to you about loaning you money."

The CHAIRMAN. Thank you. We will give your problem careful consideration.

I also submit for the record a statement submitted in lieu of appearance by Representative George Mahon, urging modification of section 175 of H. R. 8300 relating to soil and water conservation expenditures.

(The statement referred to follows:)

STATEMENT BY GEORGE MAHON, MEMBER OF CONGRESS, 19TH DISTRICT OF TEXAS, REGARDING SOIL-CONSERVATION PROVISION OF H. R. 8300

I wish to propose a modification of section 175 of H. R. 8300. This is the section which begins on page 53 of the House bill and is entitled "Soil and Water Conservation Expenditures."

I represent a district which engages in irrigation farming on a very extensive scale. We irrigate from underground water sources. We have been made fully aware by officials of the Government and by reason of experience of the urgent necessity for conserving our soil and underground water insofar as possible.

In transporting the water from an irrigation well to another part of the field, the most used method is the open ditch. However, this method results in a very large loss of water, estimated to be on the average about 35 percent. The ditches produce problems of soil erosion which are very difficult to cope with.

In recent years many farmers have adopted the practice of laying underground concrete pipe in their fields for the purpose of transporting water from the wells to wherever the water is required. This saves the 35 percent (approximate) of the water which, on the average, is lost through the open ditch method. It eliminates seepage and evaporation. It eliminates the soil erosion which is produced by the open ditch and enables the farmer to do a much better job of production.

The construction of this type irrigation system is initially more expensive than the ditch-construction process.

I recognize that it wold be unlikely that Congress would take action on a matter of this kind just to serve one area of the Nation. The fact is, this problem, in one form or another, exists in most of the States of the Union. I refer to the underground conduit method of handling drainage water, floodwater, and irrigation water in farming operations. Throughout the sections of the country where we have irrigation from surface water or from underground water this problem is present in one form or another.

I respectfully request that the committee thoroughly explore this entire subject with the view of amending H. R. 8300 to include as a farming-expense item under section 175 the cost of material and the construction of concrete and other masonry conduits which are used for soil- and water-conservation purposes on farms. Such action would, in my judgment, be in the best interest of both the Government and the taxpayer.

The CHAIRMAN. This concludes the public hearings on this bill. Next week the staff will work on the problems, following which we will have executive sessions of the committee to consider the bill.

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

STATEMENT ON H. R. 8300 BY THE EMPLOYEE'S BENEFIT FUND COMMITTEE OF THE NEW YORK STATE BANKERS ASSOCIATION, TRUST DIVISION

Esmond B. Gardner, chairman, vice president, the Chase National Bank, New York 15, N. Y.
Clifford H. Cox, vice president, The Marine Trust Co., Buffalo
Aurie I. Johnson, vice president, First Trust and Deposit Co., Syracuse
James W. Cook, assistant vice president, Lincoln Rochester Trust Co., Rochester
W. B. Dunckel, vice president, Bankers Trust Co., New York City
Ernest L. Colegrove, vice president, Guaranty Trust Co., New York City
Everett W. Wyatt, trust officer, National Commercial Bank and Trust Co., Albany
John L. Gibbons, vice president, Chemical Bank and Trust Co., New York City
Fred P. McKenzie, vice president, the Hanover Bank, New York City
Anthony J. Kearshes, vice president, Manufacturers Trust Co., New York City
George C. Barclay, vice president, City Bank Farmers Trust Co., New York City
Longstreet Hinton, vice president and trust officer, J. P. Morgan & Co., Inc., New York City

This statement is limited solely to those provisions of H. R. 8300 dealing with employees pension and profit-sharing trusts and to related provisions.

Banks ands trust companies act as trustees of many employees trusts and in such capacity administer probably more than 70 percent of the total assets held in pension and profit-sharing trusts for employees in private industry throughout the United States. They act as trustees not only under plans of other employers but in many cases as trustee under plans created by them for their own employees.

While our committee believes that many of the objectives of H. R. 8300 as applied to employees trusts are laudable, the bill contains many provisions which conflict with existing practices in the operation of employees trusts which are recognized as sound and proper in this field. The following recommendations are accordingly made with a view to eliminating such conflicts and for the purpose of improving the future operation of this new legislation.

SECTION 505 (RESTRICTING INVESTMENTS IN EMPLOYEES TRUSTS) SHOULD BE COMPLETELY OMITTED FROM THE BILL

The first and most important recommendation of our committee relates to section 505. We strongly urge that this section be completely stricken from the bill, at least in relation to trusts handled by banks or trust companies, for the following reasons:

(1) Our committee believes that the specific investment rules and restrictions contained in section 505 unduly limit sound and proper investments in employees trusts with little or no benefit to the employees themselves. These restrictions are discussed later.

(2) Banks and trust companies administer probably more than 70 percent of the total assets in private employees trusts in the United States. These institutions are under the supervision of either the United States Comproller of Currency or a State banking department. Also practically all such institutions are subject to the supervision of the Board of Governors of the Federal Reserve System.

(3) In every State, rules of law have been developed over the course of years controlling the investment of trust funds (including employees trusts) which impose a high degree of responsibility and liability on trustees in the administration of such trusts. These laws have recognized that sound investments cannot be legislated and the modern trend of these laws is in the direction of the "prudent man" rule.

(4) Recent State statutory enactments imposing controls on employees trusts have exempted from their provisions corporate trustees subject to the supervision of the United States Comptroller of the Currency, the Board of Governors of the Federal Reserve System or some State banking department. Chapter 278, laws of New York 1954; Deering's Corporations Code, State of California, section 28103.

IF SECTION 505 IS RETAINED, IT SHOULD BE AMENDED IN VARIOUS RESPECTS

Section 505, as now drawn, creates many technical problems in the investment of pension and profit sharing funds. If retained, the section should be amended as follows:

(*a*) Subsection (a) (6) and (7) limits certain investments to "5 percent of the value of the total assets of the trust" as of the end of each quarter. This may not pose problems to a regulated investment company under section 851 of H. R. 8300, but it does pose problems to a pension and profit sharing trust.

(1) Many pension and profit sharing trusts in effect today are small funds and are invested largely in bonds. As a practical matter, an investment of 10 percent or more in a single issue of high grade bonds in a small fund is considered sound. To diversify a $100,000 fund among 20 different issues is an unnecessarily expensive procedure.

(2) Even in large pension trusts, investments are made in the bonds of certain very large utility systems in an amount up to 10 percent and 15 percent of the fund. To illustrate, the Bell System represents about 91 percent of the whole telephone industry and yet, because of the definition of "one issuer" in subsection (a) (7), not more than 5 percent of the fund could be invested in the Bell System. By comparison, the total assets of the Bell System are about $12 billion and the total assets of the entire gas utility and pipeline industry about $13 billion. Yet, because the latter industry is made up principally of a large number of independent companies, it would be possible under section 505 to invest 100 percent of the fund in this industry.

Because of limitations on the authority of a corporate trustee to hold real estate in various States, serious consideration has been given by a number of pension trustees to the formation of a real estate company pursuant to section 501 (c) (2). In such a situation, the trustee would normally desire to invest more than 5 percent of the fund in the stock of such a company even though not more than 5 percent of the fund is invested in any one parcel of real estate. Furthermore, in such case the trustee would have to retain the entire voting power in the company which in itself would violate the 10 percent provision of subsection (a) (7).

(4) The limitation of 5 percent as applied to investments in real estate poses a difficult practical problem to the small and moderate size employees trusts. This is particularly true of commercial and industrial real estate.

(5) Subsection (*a*) (5) should be expanded to include investments in common trust funds which are under the supervision of the trustee.

(6) It seems inconsistent that a 5 percent limitation should be placed on investments in an employees trust which has a diversified portfolio, whereas another trust may, under subsection (*a*) (4), invest the entire fund in securities of the employer.

In reference to the 5 percent limitation, it is significant to observe that the New York statute applicable to investments by fiduciaries does not impose any quantitative restrictions on the amount of the investment permitted in any specific issue. However, if it is deemed necessary to keep a quantitative restriction, then our committee recommends the following:

(1) The restriction should be based on book value or cost instead of market value. The use of market values would require considerable additional expense in making revaluations at the end of each quarter.

(2) The restriction should apply only at the time the investment is made. A variation in the size of the fund should not force the trustee to liquidate the whole or part of an issue.

(3) Investments in common trust funds, in real estate companies of the type mentioned above, and in certain large utility groups and possibly other large industrial groups should be allowed to exceed 5 percent of the fund.

(4) The district director of internal revenue should have authority to approve exceptions of the percentage limitation where such exceptions do not run counter to the purpose of the trust.

(*b*) In subsection (a) (7), the term "other securities" should be defined very broadly. We believe it to be advantageous to pension and profit-sharing trusts and to the general economy of the country to give such trusts a high degree of flexibility to invest in any types of investments which become available from time to time, including mortgages, notes and oil royalties. It should also be broad enough to include any assets which a trustee may receive in the reorganization or liquidation of any investment which the trustee might make.

The term "other securities," in effect, constitutes placing a restriction on the type of investment which an employees' trust may make, and any definition will merely define the restrictions. With respect to employees trusts under which corporate trustees have full investment responsibility, our committee is confident there is nothing in experience which justifies imposing any restrictions on investments.

(*c*) In subsection (b) (2), the date March 1, 1954 should be changed to a later date. Many trustees unknowingly made investments in violation of section 505 after this date but before the bill was made available to the public.

(*d*) Subsection (a) (3) prevents the establishment in the future of combination plans which consist of life-insurance contracts and deposited funds held by a trustee. Under this combination arrangement, the life insurance contracts are converted to an annuity on the retirement of an employee and the deposited funds supply the additional cash required in the conversion.

This arrangement is more economical and more flexible than the use of regular annuity contracts or retirement income contracts. There are a number of such combination plans in effect today, and the bill as drafted would not permit the purchase of additional life insurance contracts and would, in effect, force the discontinuance of these plans.

We believe that provision should be made for the inclusion of life insurance contracts in combination plans as an allowable investment. Apparently under section 402 (*a*) (4) of the bill, it is contemplated that such contracts will be permissible investments.

(*e*) There have been occasions in the past where group life insurance contracts have been placed in employees trusts. In certain situations this has been a desirable arrangement, and it would be desirable if such a contract could be included among allowable investments and if the benefits of such a contract were given the same tax status as if the contract were held by the employer.

PENALTY FOR FAILURE TO COMPLY UNDER SECTION 505

The penalty for noncompliance with this section is very harsh. It is possible that through inadvertence or mere clerical error one or more of its provisions could be violated. In that event the trust would lose its exemption and the employer consequently lose the tax benefit of any contribution made in that year. Thus the employer, through circumstances wholly beyond its control, would be severely penalized, the trustee would be subject to a very substantial liability for negligence and the employee beneficiary would suffer the loss of tax benefits.

We suggest that the trustee be afforded an opportunity to correct any such violation within a reasonable period without any penalty.

RECOMMENDATION ON SECTION 503 (C)

Subsection (c) (1) might possibly be interpreted to mean that any note or bond purchased from the employer must be "secured." This, we are sure, was not the intent but if an adverse interpretation were placed on the provision, it might exclude an unsecured note or a debenture obligation of the employer. Such a note or debenture may be a high-grade credit and may be an attractive investment. The trustee might be prohibited from purchasing the debenture obligation of an employer, but, on the other hand, would be permitted to purchase the common stock of the employer. This is inconsistent. We believe that the requirement of "security" should be eliminated from subsection (c) (1).

RECOMMENDATION ON SECTION 504

This section is not appropriate to employees' trusts. There is no distinction made in these trusts between principal and income, and under section 501 (e) the trustee is required to hold and use both principal and income for the exclusive benefit of the employees and their beneficiaries. We suggest that the expression "or (e)" be eliminated, which would remove employees' trusts from the application of this section.

RECOMMENDATIONS ON SECTION 501 (E)

(*a*) In paragraph (3) (A), the requirements for nondiscrimination are actually made more restrictive as to small companies. Because of the definition of "key employees," it would not be possible to set up a plan for a small company unless that plan covered at least 25 percent of the regular employees. It would exclude plans of small companies that would cover only salaried employees, where the salaried group is less than 25 percent of the total. This is illustrated by the following hypothetical case:

A manufacturer has 500 hourly rated employees and 120 salaried employees, who qualify as "regular employees." The salaried employees include the officers of the company, the salesmen, the supervisors, the foremen, and the clerical employees.

Key employees, under the definition, would total 10 percent of 620, or 62. In the usual situation, practically all of the 62 "key employees" would be in the salaried group. This company could not adopt a plan for salaried employees because:

(1) "Key employees" represent 62 employees out of a group of 120 salaried employees, or 52 percent. This is in excess of the 10-percent limit.

(2) The total of 120 salaried employees out of a group of 620 employees represents only about 19 percent of all regular employees. This falls short of the 25-percent requirement.

The above situation is not unusual among manufacturing companies. Frequently, the percentage of salaried employees is materially less than the 25-percent requirement.

(*b*) This section does not give recognition to the following situations which exist under employees' trusts today and which should be encouraged:

(1) Many companies have 2, 3, or 4 pension plans, and some employees may be covered by more than one of these plans. Recognition should be given to multiple plans in applying the requirements of this section.

(2) A number of plans exist in which a group of employers (sometimes independent employers) pool in a single trust fund their investment and mortality experience. The Commissioner has ruled that these trusts comply with section 165 (a) of the present law. However, it is desirable that the language of the bill clearly recognize that such an arrangement is permissible. This would require modification of the language "his employees" in the opening paragraph of section 501 (e).

(3) Profit-sharing plans are frequently used as a means of providing retirement benefits. There are a number of such plans in effect today. Sometimes these plans supplement a basic pension plan and provide the additional benefit on that part of an employee's compensation in excess of $3,000 per year We believe that it should be possible under a profit sharing plan to disregard the first $4,000 of annual compensation in the same way in which it may be disregarded in pension plans.

(*c*) Paragraph 4 (B) requires that at least 75 percent of the employer's contributions and all of the forfeitures in a profit sharing plan be allocated in such a manner that the allocated amounts do not bear a higher ratio to compensation for "any covered employee" than for any other covered employee whose compensation is lower. There are a number of plans in effect today covering large groups of employees which have provisions for allocations at variance with these requirements. These plans would be embarrassed in the event they made amendments at a later date. This limitation on allocations would also have a restrictive effect on the design of new plans. The specific criticisms of this paragraph are as follows:

(1) The following types of plans which are now in wide use would not qualify:

Savings plans (which qualify as profit-sharing plans under the code) and contributory profit-sharing plans under which the employer's contributions are allocated in whole or in part on the basis of employee contributions;

Profit-sharing plans in which some weight is given to the years of service in the allocation of employer contributions. In general, this allocation operates to the benefit of the lower paid employees as a group, but there will be exceptions as to individual employees

The 25 percent discretionary provision is not adequate to cover the above variations. The situation might be remedied if the "ratio" is applied to employee groups rather than to "any covered employee" and if some practical variations are permitted in the ratio

(2) The method for allocating forfeitures in paragraph 4 (B) is only one of the methods used in plans currently in effect. Forfeitures in a number of profit-sharing plans are allocated in the same manner as earnings of the fund, i. e., in proportion to the accumulated balances of employees. This is logical in view of the fact that the amounts forfeited were accumulated over a period of years. If persons who forfeited these amounts had not been in the plan, the longer service employees would have been allocated larger amounts and would have accumulated a relatively greater fund than the short service employee. It is possible that in some small special situations this procedure might result in discrimination, but in the larger plans covering many employees such discrimination is improbable.

RECOMMENDATION ON SECTION 403 (C) (1)

This section continues the exemption of trusts under plans which are currently exempt under section 165 (a) of the present law. However, on the basis of experience, it will be necessary from time to time to amend such plans. It should be made clear that employers may make amendments to such plans in a reasonable manner without having to qualify the entire plan as if it were a new plan under section 501 (e).

RECOMMENDATIONS ON SECTIONS 511 TO 515

These sections impose on employees trusts the same restrictions in regard to investments as are imposed on charitable organizations. Our committee believes that there are good reasons for treating employees trusts differently under these sections and possibly eliminating entirely the application of these sections to employees trusts. The following are the fundamental differences between an employees trust and a charitable organization.

(1) The amounts paid from an employees trust are subject to tax in the hands of the recipient, whereas funds paid by a charitable organization are not so taxable. In an employees trust there is merely a postponement of the collection of the taxes on the amounts contributed by the employer and on the earnings of the trust, and not elimination of taxes as in the case of a charitable organization.

(2) The accumulations of additional earnings in an employees trust arising from the use of mortgage indebtedness in a leaseback, result in a reduction of the amount which may be contributed and claimed as a tax deduction by the employer. However, the accumulations of such additional earnings in a charitable organization have no such effect.

However, if sections 511 to 515 are made applicable to employees trusts, the following amendments should be considered:

(1) Leases to the employer, subject to mortgage indebtedness, might be considered in the category of a "security of the employer" and might be exempt from the application of these sections. Such an arrangement sometimes facilitates the funding of the past service liability to the benefit of employees.

(2) A number of employees' trusts entered into leasebacks involving mortgage indebtedness prior to March 1, 1954. It is suggested that in no event should the law be made applicable to leasebacks held as of March 1, 1954. The application of the restrictions of these sections would then parallel the application of the restrictions on investments imposed by section 505.

RECOMMENDATION IN CONNECTION WITH SECTION 2039

This section provides that a joint and survivor annuity payable under an employees trust forming part of a qualified plan shall not be taxed for estate-tax purposes except to the extent of the employee's contribution.

It would appear that similar provision should be incorporated in relation to the gift tax, under chapter 12 of subtitle B of H. R. 8300, with respect to the irrevocable election of a joint and survivorship annuity option.

STATEMENT OF WALTER H. KAMP ON BEHALF OF BRISTOL LABORATORIES INC. CONCERNING THE SUGGESTED ADDITION OF SECTION 40 TO PART IV—CREDITS AGAINST TAX, OF THE PROPOSED BILL (H. R. 8300)

Chairman Millikin, members of the Senate Finance Committee, gentlemen, my name is Walter H. Kamp; I am comptroller of Bristol-Myers Co., New York City; and am making this presentation on behalf of Bristol Laboratories Inc., a wholly owned subsidiary of said Bristol-Myers Co. Bristol Laboratories Inc. is one of the major penicillin producers in this country. We wish to suggest the addition of a new section, section 40, to part IV—credits against tax, in subchapter A of chapter 1 of the proposed bill (H. R. 8300).

While the current internal-revenue laws provide in some measure for the averaging of net incomes of corporations subject to excess profits taxes by permitting a 1-year carryback and a 5-year carryforward of net operating losses and unused excess profits credits nevertheless the present law has produced substantial inequities in relative tax burdens due to the 1-year carryback limitation. The new proposed Internal Revenue Code recognizes this inequity by providing for a 2-year carryback and a 5-year carryforward of net operating losses. Such

proposed new provision does not relate to unused excess profits credits and is not applicable to taxable years beginning before January 1, 1954.

With respect to the excess-profits tax for the years 1950–53, it would seem that two companies having the same total net income and the same excess-profits credit for that period should pay approximately the same excess-profits tax. However, in 1 specific instance 1 company paid a tax of $1,500,000, but it would have paid only $400,000 if its earnings for 1951 and 1952 had occurred in reverse order. Similarly, another company having the same total income and the same credits but with a different pattern of years in which the earnings were realized would have paid only $400,000. It is submitted that Congress never intended any such discrimination nor would it permit this to exist if it were fully cognizant of the widely varying impact of the present law. Exhibit A attached hereto sets forth these earnings patterns and the resulting excess-profits taxes.

This unreasonable discrimination between taxpayers whose only difference in taxable income is not that of amount but of chronological order is the result of the 1-year limitation on carrybacks, particularly with respect to the last excess-profits tax year, 1953. A company which had an unused credit or a net operating loss for the years 1950 and 1951 would be able to apply such credit or loss to level out the income of at least three other excess profits tax years. If such unused credit or loss arose in 1952, it could be applied to level out the income of at least two other excess-profits tax years. If, however, the unused credit or loss occurred in the year 1953, it could be applied to level out the income of only 1 other excess-profits tax year.

The simple remedy for this inequity would be to restore the 2-year carryback period in effect for the years 1940–45 and now again proposed for 1954 and subsequent years. Such an amendment would have to be retroactive, which might result in substantial refunds and which apparently is contrary to the views of the House Ways and Means Committee concerning retroactive tax proposals. Accordingly, a prospective amendment is proposed which might afford some measure of relief against this inequity. It consists of a new section to be added to the presently proposed Internal Revenue Code reading as follows:

"SECTION 40—CREDIT WITH RESPECT TO UNUSED EXCESS PROFITS CREDITS.

"(a) Allowance of Credit—

"For each of the first three taxable years beginning after December 31, 1953, the credit computed under subsection (b) shall be allowed as a credit against the tax imposed by this chapter.

"(b) Determination of Credit.—

"(1) The credit for the first taxable year beginning after December 31, 1953, shall be the lesser of—

"(A) The entire amount of the credit carryover determined under subsection (c), or

"(B) The amount by which the tax imposed under this chapter for such taxable year exceeds the credits against such tax allowed under this chapter, without regard to the credit allowed under this section.

"(2) The credit for each of the 2 succeeding taxable years shall be the lesser of—

"(A) The amount by which the credit carryover determined under subsection (c) exceeds the total of the credits allowed under subsection (a) for the preceding taxable year or years, or

"(B) The amount by which the tax imposed under this chapter for such taxable year exceeds the credits against such tax allowed under this chapter, without regard to the credit allowed under this section.

"(c) Credit Carryover.—

"The credit carryover referred to in subsection (b) shall be 30 percent of the unused excess profits credit adjustment for the first taxable year beginning after December 31, 1953, computed as if such year were a taxable year under section 430 of the Internal Revenue Code of 1939.

"(d) Limitation.—

"The aggregate of the credits allowed under subsection (a) for all taxable years shall in no event exceed the aggregate of the excess-profits taxes assessed against the taxpayer for all taxable years under section 430 of the Internal Revenue Code of 1939."

Under this proposed amendment unused excess profits credits which cannot be applied to reduce excess profits taxes because of the carryback limitations and the expiration of the excess profits tax would be carried forward to subsequent

years as the basis of the credit against income tax. The total credit for all subsequent years would be 30 percent (the excess profits tax rate) of the total unused credits which would be carried over to 1954 if that had been an excess profits tax year. To prevent unwarranted reductions in tax, the maximum credit for all the years would be limited to the amount of the total excess profits taxes actually assessed against the taxpayer during the effective period of the recent excess profits tax.

The benefits of this amendment would be restricted to taxpayers who had unused excess profits credits in 1952 and 1953 which they were unable to apply in reduction of their excess profits tax liabilities. Any taxpayer having 1950 or 1951 unused excess profits credits would either have applied such credits as carrybacks or carryovers or would have had no excess profits tax liability for the entire period of the tax. An unused excess profits credit in 1952 could become the basis of the credit in 1954 or subsequent years only if there had been an excess profits tax in 1950 and little or no such excess profits tax in 1951 and 1953. The principal application of this proposed amendment would be to those taxpayers who paid excess profits taxes for 1950 or 1951 and had unused excess profits credits in 1953.

In lieu of the usual 5-year carryforward, the period in which these special credits against income tax may be applied is limited to the 3 years beginning with the first taxable year commencing in 1954. Since the recent excess profits tax was in effect for only a 4-year period, a 3-year carryforward of these special credits will give a corporation with an unused excess profits credit in 1953 a leveling out period comparable to that enjoyed in the excess profits tax years by corporations which had unused credits in 1950 or 1951.

No refunds of prior years' income or excess profits taxes can arise under the proposed amenement. In a proper case, the discrimination we have described will be corrected to some extent by a reduction of future income taxes.

Excess profits tax—Comparative effects of 1-year carryback rule

	1950 ½ year [1]	1951	1952	1953	Total 3½ years
Corporation A:					
Excess profits net income	$1,510,000	$7,654,000	$531,000	($1,865,000)	$7,830,000
Less credits:					
Excess profits credit	809,000	1,687,000	1,958,000	2,000,000	6,454,000
Unused excess profits credit, 1952		1,427,000	(1,427,000)		
Total credits	809,000	3,114,000	531,000	2,000,000	6,454,000
Adjusted excess profits net income	701,000	4,540,000		(3,865,000)	1,376,000
Excess profits tax, 30%	210,300	[2] 1,320,315			1,530,615
Corporation B					
Excess profits net income	1,510,000	531,000	7,654,000	(1,865,000)	7,830,000
Net operating loss, 1953			(1,865,000)	1,865,000	
Excess profits net income as adjusted	1,510,000	531,000	5,789,000		7,830,000
Less credits:					
Excess profits credit	809,000	1,687,000	1,958,000	2,000,000	6,454,000
Unused excess profits credit, 1951	578,000	(1,156,000)	578,000		
Unused excess profits credit, 1953			2,000,000	(2,000,000)	
Total credits	1,387,000	531,000	4,536,000		6,454,000
Adjusted excess profits net income	123,000		1,253,000		1,376,000
Excess profits tax, 30%	36,900		375,900		412,800
Corporation C					
Excess profits net income	1,100,000	2,300,000	2,000,000	2,430,000	7,830,000
Less excess profits credit	809,000	1,687,000	1,958.000	2,000,000	6,454,000
Adjusted excess profits net income	291,000	613,000	42,000	430,000	1,376,000
Excess profits tax, 30%	87,300	183,900	12,600	129,000	412,800

[1] Income and credit amounts in 1950 column are 1½ of annual amounts.
[2] Maximum limitation, 17¼ percent of $7,654,000.

COMMENTS

Corporation A: Total excess-profits tax, $1,530,615; effective rate, 111 percent.

The tabulation for corporation A reflects the actual results for an existing corporation.

Corporation B: Total excess-profits tax, $412,800; effective rate, 30 percent.

Corporation B differs from corporation A only in that the order of the 1951 and 1952 earnings has been reversed. The result is to cut the tax by over $1,100,000.

Corporation C: Total exces-profits tax, $412,800; effective rate, 30 percent.

The tabulation for corporation C illustrates the results for a company whose trend of annual earnings parallels the general trend of total corporate profits as reported by the Department of Commerce. While its total earnings for the period and its credits are the same as those of corporation A, its total tax is $1,100,000 less than that of corporation A.

STATEMENT TO SENATE FINANCE COMMITTEE BY ARTHUR STEDRY HANSEN, CONSULTING ACTUARY, LAKE BLUFF, ILL., RE TECHNICAL PROBLEMS IN PROPOSED PENSION, PROFIT SHARING, AND RELATED SECTIONS

DEFERRED PAYMENT PLANS

My name is Arthur Stedry Hansen. I operate a consulting actuarial service for employers in matters relating to their pension, profit sharing and related employee benefit programs at 1080 Green Bay Road, Lake Bluff, Ill.

Tomorrow, April 24, 1954, I will have been engaged in this business for exactly 30 years. During this period, I have served many hundreds of employers, of all sizes in all types of business, on their pension and related employee benefit problems. We do not sell plans, insurance or investments. We offer only professional and technical services to employers or plan administrations

I was the actuary for the Vandenberg Senate Subcommittee on Pension, Profit Sharing and Incentive Plans in 1939; and I was a special consultant to the Treasury in 1942 and 1943 assigned to assist the then Commissioner of Internal Revenue in the technical problems involved in the 1942 law amendments on pension and profit-sharing trusts.

I have been working continuously with the various divisional offices and the Washington office of the Internal Revenue Bureau on problems arising in the administration of the present tax laws relating to pension, profit sharing, and other employee benefit plans. During this period, we have been faced with all sorts of problems of (a) approval, administration, and tax deduction allowances of several hundred employers and (b) the Internal Revenue Bureau in applying the present law and in applying and developing the present rules, regulations, etc.

I assume that policy is determined by Congress with the assistance of the Treasury and the public through committees, hearings, and conferences. The following remarks apply to the problems involved in accomplishing the policy objectives indicated by the proposed code language. If the policy is changed as a result of these hearings or further consideration, the technical problems will perhaps change. The substance of the comments will, however, be helpful in many cases even under such circumstances.

The changes in the proposed law appear generally to reflect the policy set forth in the budget message of President Eisenhower transmitted to Congress January 21, 1954, which was as follows: "The conditions for qualifications for special tax treatment of employees' pension plans are too involved. Such plans are desirable. I recommend that the rules be simplified and that greater discretion be given in establishing plans for different groups of employees, so long as there is no discrimination in favor of key executives or stockholders."

Unfortunately, however, while the language of the proposed law appears to be simplified and to provide greater discretion, revised and untried concepts are included with the result that actually many plans possible under the present law would actually not be permitted or would be restricted under the proposed language and, in many instances, the uncertainties, administrative work, and dependency upon Treasury interpretations and regulations would be increased.

In general, the proposed language is patterned after the present law. The original errors and limitations are in many instances continued. Economic conditions and plan patterns have changed since the 1942 law was enacted.

Additional changes are required today. Since the entire code is being rearranged and redrafted, the experience gained since 1942 should be included in the revisions at this time so as to clarify the continuing provisions and make them consistent with the proposed policy changes.

The following comments arise out of (a) our analysis of the problems involved in the various phases of administration of several hundred existing pension trusts over many years and (b) the desire to reduce the uncertainties and detail now involved in qualifying and maintaining qualified pension plans. The comments are limited and directed primarily to:

1. Simplifying the law, regulations, and the administrative work of taxpayers.
2. Clarifying present and proposed uncertainties in the law, and
3. Modifying requirements to avoid difficulties for both existing and new plans within the policy limitations set forth by the President in his budget message.

DEDUCTIONS TO EMPLOYERS

1. Definitions

Section 403 refers to an employees trust, annuity plan, and a deferred payment plan in the caption. In general, these are satisfactory although, as indicated elsewhere, it is desirable that these terms be defined and that they be used in the specifically defined manner each place in the law. The words in the caption should be changed to the proper terms in accordance with the definitions to be supplied. The caption might read "Deductions for Contributions of an Employer Under a Deferred Payment Plan."

2. Plan qualification requirements

Section 403 (a) generally appears to be somewhat simplified and satisfactory except again for the necessity of using specifically defined terms referring to trusts, plans, etc. The reference should be changed so as to agree specifically with the defined terms referred to elsewhere in these comments. Requirements for qualified plans, and definitions of nonqualified plans, should be specified at this place in the regulations rather than in section 503 (a) relating only to trusts to simplify the provisions and avoid confusion between plans, trusts, etc.

3. Qualified pension plan

Section 403 (a) (1) relates to pension trusts. Actually, this section applies to pension benefits under a plan in an employees' trust. In order to carry the distinction now necessary, between the so-called pension and profit-sharing plans, it is desirable that the defined terms be used. Actually, the provisions of this section should be limited to contributions to employers' trusts for costs of benefits under qualified pension plans. If this distinction is made, the problems arising as to the method of taxing nonqualified plans will be simplified and made possible on a specific basis. Incidentally, reference is made to a pension trust described in section 501 (e). Pension trusts as described in section 501 (e) include profit sharing and other plans. Proper definitions will avoid these problems.

Actually, this section should refer to contributions under qualified pension plans (whether paid to an exempt trust under section 501 (e) or to an insurance company under contracts meeting the irrevocable and reapplication of refunds and other returns requirements).

4. Alternative determination

Section 403 (a) (1) provides for deductions for contributions to pension trusts under the following subparagraphs (A), (B), and (C), as is generally provided under the present law.

The determinations under (B) and (C) are distinctive and inherent in the method of funding costs under the plan. It is unnecessary to provide these as alternatives. However, the limitation under (A) is specifically applicable to the valuation and cost determination in (C).

The language should therefore be clarified so as to specifically provide that the limitation for any year is the greater of the amount determined under (C) if such method of funding is used under the plan or (A) whichever is the greater for each year.

5. Minimum pension deduction

Section 403 (a) (1) (A) apparently provides an increase from 5 percent under the present law to 10 percent under the proposed law. While this is an apparent liberalization, actually the base upon which the percentage is applied has been

more restricted so that, in effect, in many instances, the proposed law will result in more limited deductions than under the present law.

If it was the policy of Congress to make this provision more liberal, the 10 percent is satisfactory, but it should be applied to a basis similar to that under the present law. If the policy of Congress was to revise the basis upon which the limitation would be applied, the present law is more satisfactory since it permits a simple specific calculation on available information, whereas the proposed language necessitates a very complicated and involved actuarial determination on the basis of individuals or groups to determine when individual past service costs have been fully funded.

The second sentence of this paragraph attempts to somewhat limit the complicated work involved in making the determination. Actually, since a large number of plans do provide different rates or types of benefits or are offset by benefits provided in some other program, the limitation is ineffective in a large number of cases so that actually detailed calculations would need to be made on every individual or groups of individuals. Such a calculation would involve an elaborate set of regulations providing for acceptable bases for determining such costs, methods of allocating income and gains from year to year, and other involved technical problems. If for no other reason, there is perhaps adequate justification for simplifying this provision based upon the administrative difficulties alone.

Since certain valuations are required before the end of a fiscal year of an employer, and since information on current compensation of employees is not necessarily completely available until sometime after the end of the year, a specific provision should be made that the compensation to be considered is to be that for the taxable year or any other year ending within the taxable year selected by the employer if followed consistently.

Compensation, for this purpose, should be the total compensation of the employees included in the plan regardless of any theoretical funding basis for individual employees. Actually, it is impossible in most trusteed plans to allocate contributions to past service of individuals. Normally, contributions are paid in to a trust and used to provide benefits upon retirement.

The percentage of compensation limitation in this paragraph should be limited only by the full funding of past service costs of all the pension plans of the employer as determined on the method of valuation consistently used for determining costs. In other words, the percent of compensation would be applicable until such time as the total unfunded past service requirement in all pension plans funding under the (C) method is funded. Thereafter, the costs would be limited to the normal costs of the plans. Such a limitation on full funding would be necessary in order to limit deductions for advance funding. Any limitation on the payroll considered for this purpose would be discriminatory against pension plans as related to profit-sharing plans although the comparison is difficult and perhaps not too valid.

6. Future funding only

Section 403 (a) (1) (B) retains the provisions of the present law. The limitation in the event 3 individuals whose cost is more than 50 percent of the remaining unfunded cost is somewhat discriminatory, limited and generally inapplicable. Furthermore, it is difficult to determine because of the need for actuarial assumptions and procedures in allocating and defining costs. It would be desirable to eliminate the need for determining whether any three individuals account for more than 50 percent of the unfunded cost. The requirement of spreading the costs over at least 5 taxable years could be applied to and limited to persons with less than 5 years of future service to normal retirement date as provided in the plan, rather than applying to the three individuals accounting for 50 percent of the remaining cost.

7. Past and future funding

Section 403 (a) (1) (C) changes the basis upon which the 10 percent of past service is determined from that in the existing law. While the revised language would, however, affect plans differently, and necessitate an immediate recomputation of the past service base in every existing pension trust, it will thereafter provide a simpler and less discriminatory basis for this purpose.

Requiring a separate amortization of past service costs, however, is definitely discriminatory against the employer establishing a plan on a conservative basis as against one establishing a plan on a more liberal basis. If the increased benefits under an amended plan are still reasonable and within the limitations permitted for qualified plans, it would have been possible for the employer to

have provided the larger benefits at an earlier date and to have received additional deductions in prior years by including such benefits in the plan at an earlier date. The fact that the increase was deferred, actually results in lower tax deductions in prior years. Such an employer should not be again penalized in requiring that the added costs be spread over a longer period into the future. In fact, there is a basic justification for including in the past service base at all times, the entire amount under all of the pension plans of an employer regardless of the number of plans and the dates of adoption or change. The limitation in the proposed law requiring separate calculations for supplemental costs, should therefore be eliminated so that all costs, regardless of the time they are included in the plan, would be considered in the automatic determination of the 10-percent base for years in which any adjustments are made, and for all years thereafter until full funding is completed. Provision should also be made so as to specifically indicate that the limitation should be applied to the total past requirements of all pension plans of an employer rather than to each plan separately.

The proposed language does not permit a deduction of 10 percent of the interest on the unfunded balance during the year as is permitted under the present regulations. Consideration should be given to the allowance of 10 percent of the interest on the unfunded accruing during the current year until paid. Incidentally, normal costs used in this paragraph should be defined to include normal costs plus interest on normal costs accruing during the year so as to correctly distinguish between the interest applicable to the unfunded and the normal cost.

The revised language has apparently inadvertently omitted the limitation restricting the deduction for contributions to the normal cost and interest thereon for any year after the unfunded costs for service credited for prior years is completely funded.

8. Deduction carryover

Section 403 (a) (1) (D) should be modified so as to clearly indicate that it is to be applied to the total of all pension plans of an employer or group of employers. It would also be desirable to provide for the carryover of amounts paid in excess of deductions allowable in prior tax years as well, so as to give an employer a full deduction for all contributions made under a qualified plan.

Because of the revision in the treatment of deductions under qualified and nonqualified plans, a specific statement should be included in this paragraph limiting the carryover of deductions to those made under qualified plans. Deductions under nonqualified plans will be provided for elsewhere.

9. Insured pension plans

Section 403 (a) (2) relates only to insured pension plans. Since, in general, the provisions of section 403 (a) (1) really apply to pension plans rather than to pension trusts, it would be desirable to consolidate this paragraph with the previous paragraphs so that the limitations would equally apply to all pension plans, or portions of pension plans, whether included in trusts or insurance contracts.

The reference to refund of premiums should be clarified so as to include the return of all amounts arising out of the operation of the plan. This might involve dividends or benefits payable to an employer or other similar items. The law should specifically indicate that no trust is necessary if the insurance company issuing the policies will legally, through contract provisions, agree to meet the same requirements as to irrevocability and reversions as are applicable to qualified trusts.

10. Qualified profit-sharing plans

Section 403 (a) (3) should have the captions revised to be consistent with the definitions and procedures used in other sections. The partial definition in paragraph (c) following is inadequate for this purpose.

11. Limits, profit-sharing deductions

Section 403 (a) (3) (A) should also be modified so that the language refers to the defined terms and the test is applied to the plan or plans rather than to the trust. The reference to purchase of annuity contracts under a profit-sharing plan somewhat overlaps the reference under the existing definition of terms in section 403 (a) (2). If section 403 (a) (2) is consolidated with section 403 (a) (1) as previously suggested, the present method of reference in the first sentence of section 403 (a) (3) is satisfactory although, of course, the language and use of

terms should be parallel and consistent with the similar use in section 403 (a) (1). The comments under section 403 (a) (2) will likewise apply to the reference to the purchase of annuities.

A specific provision should be included in the profit-sharing reference to annuity purchases so as to clearly indicate under what circumstances trusts will be required and under what circumstances contracts can be purchased directly without a trust. Under the other requirements in the code, it would appear that, since forfeitures have to be reallocated, a trust will be necessary unless specific provisions are set up to the contrary in the law.

The references to trust, or under the plan or similar trust or plan, etc., should be modified to clearly agree with the defined terms, and the language should clearly indicate that the tests are to be applied to all profit-sharing plans of the employer or employers as a group.

12. Affiliated employers

Section 403 (a) (3) (B) is a new provision involving specific recognition of more than one employer under a plan. In general, such a provision is desirable although it should be simplified in its application and should be applicable to all deferred payment plans rather than only to profit-sharing plans.

In general, it would also appear that it will be necessary to coordinate this language with the definitions in the remainder of the plan so as to clearly indicate this particular limitation is applicable only to the type of profit-sharing plans with contributions based upon profits as distinguished from other accumulation plans and money purchase plans, the contributions of which are based upon other factors.

The limitations to accumulated earnings and profits would appear to apply only to plans in which contributions are based upon profits as distinguished from plans based upon other factors such as money purchase pension plans.

13. Multiple plans

Section 403 (a) (3) (C) provides a partial definition of a stock bonus and profit-sharing plan. This language should be made more specific and coordinated with all the defined terms applicable to deferred payment plans so as to avoid ambiguity. A general section on definitions would simplify the problem.

The requirement that, if more than one plan exists, all profit-sharing plans are to be considered jointly, is satisfactory for applying limitations, but it is desirable that the distinction be made between a pension plan, a so-called profit-sharing plan, and a nonqualified plan, since these need to be considered separately from profit-sharing plans.

14. Foreign trusts

Section 403 (a) (4) is a new section required because of the limitation on trusts created in the United States in section 501 (e). As indicated in the comments on section 501 (e), the reference should be to a trust maintained, as distinguished from a trust created or organized. The basis for deductions of contributions should, however, be related to the plans, as distinguished in the foregoing comments, rather than the trust. This subsection appears unnecessary if limitations are properly applied to plans. The proper reference will appear in section 501 (e).

15. Nonqualified plans

Section 403 (a) (5) provides, in effect, that the employer will obtain a deduction in the year and to the extent amounts are actually distributed or made available under a plan not meeting the requirements for qualification. The statement of theory appears to be more satisfactory than that in the present law although the method of accomplishing the result is not specified.

It would be desirable to define the phrase "made aavilable" so that taxpayers can determine directly from the law the consequences of various acts without the necessity of obtaining rulings and waiting for precedent and regulations.

If the amounts are provided by the employer directly, or if the phrase "made available" applies upon the purchase of an annuity, the provision is satisfactory. If, however, a trust is created, or if the purchase of an annuity is not construed as "made available" at the time of purchase, the problem is complicated by interest and other gains or losses between the time of the contribution and the distribution. A simple method would be to specifically provide that the income of any trust or the increment on any contract would be considered income of the employer and not taxed to the employee, or to the trust. The results of creating a trust or purchasing a contract would then be the same as if the employer had

merely provided the same benefit without such trust or contract. A deduction could then be specifically allowed for each payment under such a plan since, eventually, the total amounts of the payments would exactly equal the contributions plus the interest and other gains. It would, therefore, not be necessary to allocate the accumulations or income to any individual or to require complicated calculations or regulations for the administration of the provision. The provision would be basically equitable from a tax point of view, and as between employers using different types of plans, and as between nonfunded plans or plans funded with a trust or an insurance contract.

If such a specific provision were made for so-called nonqualified plans, the problems of determining tax deductions under a qualified plan, which may be disqualified for a period, or which may include supplemental benefits of an unqualified nature, would also be automatically answered on a simple and nondiscriminatory basis

In general, the tests of the entire section 403 should be based upon types of benefits under plans regardless of the combinations or arrangements of the provisions of the plans, contracts, or trusts themselves. The three general categories would be (*a*) qualified pension plans, (*b*) qualified profit-sharing plans, and (*c*) unqualified plans of all types. Proper definitions would be required but such definitions would clarify the application of all of the sections relating to deferred compensation plans

16. Limitations multiple plans

Section 403 (a) (7) provides a limitation on deductions in the event more than one plan of certain types is in existence for an employer. It appears desirable to modify this section so as also to take into consideration clearly the effect of other nonqualified plans.

If the plans are redefined, as indicated above, into three categories, the provisions of this paragraph could be simplified and made more specific. All of the plans of each type would then be considered together as a consolidated plan of the employer or employers of each type. The deductions allowable under the nonqualified plans would be, in a sense, equivalent to a section 212 or section 162 expense and would, therefore, not be included in the liimtation of this paragraph. The joint limitations of this pargarph could then be applied in the event, and limited to, an employer or group of employers having a plan of the pension type and a plan of the profit-sharing type. The limits applicable to all pension plans as a group would be provided in section 403 (a) (1), the limits to all profit-sharing plans as a group would be provided in section 403 (a) (3), and this section would apply clearly only to situations in which both types of plans existed simultaneously with an employer or group of employers

The last sentence, relating to combination plans if no employee is included under more than one, should be expanded to consider the situation in which some of the employees are included in more than one plan whereas others are not, or the more general situation in which the employees covered by different plans differ. The limitations should apply only to the extent that the same employees are included in more than one plan.

If the qualifications for eligibility and discrimination in qualified plans is liberalized, and a limitation placed upon the benefits available to any individual employee, the limitation in this section should be completely eliminated; the limitations upon pension and profit-sharing plans would be sufficient. If, however, eligibility requirements are such that there is no limit to the possible benefits of an employee under all of the plans of an employer, then the limitation in this paragraph is perhaps applicable, although it should be limited to the portion of the costs applicable to employees included in the multiple plans.

If a limitation is necessary, it could be determined by ascertaining the limitations of all of the pension plans as a unit, and the profit-sharing plans as a unit. These costs would be determined on the basis of a percentage of the total compensation of the employees included in each of the plans. The limitation could then be determined by applying the pension percentage to the compensation of the employees not included in a profit-sharing plan, plus the percentage limitation in the profit-sharing plan applied to the compensation of employees not in the pension plan, plus 25 percent of the compensation of the employees included in both types of plans. The 30-percent limitation could also be made applicable to the same group.

17. Nonqualified plans

Section 403 (b) could be materially simplified by avoiding the reference to treatment under other sections, and making a specific statement to the effect that

any plan of deferred compensation other than those qualified under section 403 (a) would permit deductions of the amounts paid or made available to beneficiaries at the time of distribution whether such amounts were paid directly by the company or by a trust or insurance company, and that no deductions would be allowed for contributions to a trust or an insurance company at the time the contribution is made if the plan does not meet the requirements of a qualified plan at the time the contribution is made.

18. Section 165 (a) trusts

Section 403 (c) (1) relates to the continued exemption as a trust. This entire subsection should be transferred to section 501 (e) so as to clearly indicate that existing trusts continue to be exempt under the provisions of section 501 (a) as distinguished from a possible interpretation that, since this provision is included in section 403, the language is merely for the purpose of supporting the continuing deductions under such plans, rather than the continuance of qualification as an exempt trust.

19. Section 23 (p) deductions

Section 403 (c) (2) generally provides for continued deductions on the basis of the existing law and regulations for plans qualified at the time the revised code is adopted. Fundamentally, this is desirable although the procedure raises numerous questions.

For example, if the social-security law is amended, in effect the regulations on integration should be modified. A question then arises as to whether the regulations under the old section 23 (p) would have to be maintained up to date for a continued determination of deductions or whether the present regulations would apply arbitrarily, irrespective of the basic changes which would normally affect deductions.

A further question arises in the case of an existing plan that does not have an official approval of the Commissioner. In such case, does the Commissioner issue approval of the old law and old regulations, and, if so, what basis is there for making decisions on questionable points under the superseded regulations?

If an existing plan is amended after the new law becomes effective, is it necessary for the entire plan to meet the requirements of the revised law, or only the amended portions? If the entire plan has to meet the requirements, the savings effect of this provision is of little value since the revised law as proposed would not qualify a large number of integrated plans.

If the language contemplates that only the amendment will have to qualify under the revised law, a specific set of provisions or regulations will be necessary to determine how to coordinate the requirements of the two plans. This would appear practically impossible.

The most satisfactory manner of handling existing approved plans would be to continue in the present law simple alternatives which are basically the same as those in the present law. In this way, the regulations would be continued to the extent necessary and plans would continue qualification under the revised law. The problems of amendments and maintaining two sets of regulations, and the confusion as to which set of regulations will apply, would then be eliminated.

EXEMPT TRUSTS

1. Definitions

Section 501 (e) is captioned "Employees' Pension Trusts, Etc." The code does not define "employees' pension trusts" and this specific phrase is used nowhere else in the code. "Employees' trusts" is used in the caption to section 403. "Pension trusts" is used in section 403 (a) (1). "Pension plan" is used frequently in sections 403 and 501, generally referring to pension and annuity plans as distinguished from profit-sharing and stock-bonus plans.

Section 501 (e) actually applies to all types of deferred-payment trusts and is not limited to pension trusts. The confusion of the present law is continued under the proposed code language. The caption should perhaps refer to "deferred-payment trusts," and in any event the various terms should be defined and used consistently throughout the code.

2. United States trusts

Section 501 (e) limits a qualified trust to a trust created or organized in the United States. This is a limitation not existing in the present law. The limitation should perhaps, however, be applied to a trust maintained in the United States rather than to a trust created or organized in the United States.

3. Affiliated employers

Section 501 (e) refers to a "trust forming part of a * * * plan of an employer for the exclusive benefit of his employees or their beneficiaries." Since many trusts cover employees of more than 1 employer and many plans include several related or affiliated employers, and since trusts may apply to less than all the employees of an employer, and since more than 1 plan may be involved, the language should be clarified so as to, for example, refer to a "trust forming part of a deferred-compensation plan or plans of an employer or group of related or affiliated employers for the exclusive benefit of one or more employees of such employers and certain beneficiaries of such employees."

4. Plan required

Section 501 (e) (1) differs from the present law because of the addition of a reference to other employers under section 403 (a) (3) relating to profit-sharing plans. The change should not be limited to employers with profit-sharing plans or to single plans but should apply to all included plans and to all included employers, and to all types of deferred-payment plans. Language such as the following would meet these requirements: "If contributions are made to the trust by such employers, or employees, or both, for the purpose * * * in accordance with such plan or plans."

5. Exclusive benefit

Section 501 (e) (2) refers to "his employees or their beneficiaries." To be consistent with the previous changes, these words should also be changed to provide "the employees and beneficiaries included in such plan or plans."

6. Qualified plans

Section 501 (e) (3) and section 501 (e) (4) relate to the requirements for a qualified plan or plans. Actually, the tests of eligibility and discrimination are applicable to plans and not trusts. The specifications of a qualified plan should, therefore, be made part of Subchapter D: Deferred Payment Plans, rather than Subchapter F: Exempt Organizations. Such a change will materially simplify both subchapters and eliminate confusion between qualified and nonqualified trusts, plans of all types, and annuity contracts.

The language in section 501 (e) (3) could then apply to all deferred-payment plans as defined in subchapter D and section 501 (e) (4) could then specify the exempt status for portions of assets applicable to qualified plans and the special treatment for nonqualified plan benefits.

7. Nonqualified plans

Section 501 (e) should include an additional paragraph providing that if nonqualified deferred-payment benefits are available under any trust, and if the assets and income are segregated or separately accounted for between the qualified and nonqualified portions, the trust will be exempt, but the income on the assets representing the nonqualified part will be taxable to the employer as income.

The inclusion of nonqualified deferred-payment benefits in a trust will not disqualify the trust, but will merely require a special tax on income in a manner similar to that provided in section 503 for income from prohibited transactions. Such a provision will establish a basis for determining the tax deduction on nonqualified benefits. It will also provide a satisfactory basis for plans which might technically fail to meet a qualifying requirement at any time. It will also provide a basis so that the deductions of the employer can equal the amounts paid out of the trust to the employee or beneficiary in full at the time of payment without the necessity of any adjustments.

8. Section 165 (a) trusts

Section 501 (e). It would appear desirable to add an additional paragraph covering the substance as now set forth in section 403 (c) (1) relating to the continuance of the exempt status of trusts qualified under section 165 (a). This is necessary in section 501 (e) on exempt trusts so as to assure future exemption of the trusts, and it is unnecessary under section 403 relating to deductions of an employer. Section 403 deductions will be adequately covered by reference to exempt trusts. A question as to the taxability of the trust itself might arise if the specific language is not included in section 501, an implication being that the inclusion in 403 is only for the purpose of protecting the deductions of the employer.

It would appear also that some provision should be made to indicate that such trusts will continue to be exempt if they have been qualified by the Treasury as meeting the requirements of section 165 (a) on the date the new code becomes effective until amended or until the Secretary, or his delegate, has notified the taxpayer of an intention to disallow continuing qualification after providing a hearing, etc.

If the present language of the proposed code is modified so as to, in substance, permit as a minimum the same types of plans that were permitted under the law prior to amendment, no further problems appear to arise. If, however, only an arbitrary discrimination test is provided in the revised code (which is undesirable), it will be necessary to make provision for a transition in the event an existing plan is amended so that the amendment will not necessitate a complete readjustment of the old plan under the new law and thus, in effect, nullify the provision for continued qualification of plans under the old requirements.

Since the problem of adequate control of such amendments and the determination of whether they are substantial enough to require a change to the new provisions, are almost impossible of determination, the only satisfactory solution, would be to provide continuing alternative requirements for qualification similar to and at least as liberal as those in effect at the time the code is revised. This is perhaps particularly true of pension plans. It is perhaps not too important with respect to profit-sharing plans since, if a profit-sharing plan is amended, it can perhaps easily meet the new liberalized requirements under the proposed code language.

A simple basis for testing pension plans comparable to that used in profit-sharing plans so as to avoid discrimination because of the type of plan is desirable, if this can practically be done. The addition of the other integrated discriminatory tests as an alternative means of meeting the requirements for qualification and pension plans must, in any event, be added to protect present plans in the future and to avoid limiting the requirements of future plans.

QUALIFIED PLANS

1. Code arrangement

Under section 165 (a) of the present law, discrimination tests are a part of the requirements for a qualified trust. This procedure complicates the application of the tests since they actually apply to plans and not trusts. The procedure also requires special reference and provisions to annuity plans, and does not clearly provide for the treatment of income of trusts under certain nonqualified benefit conditions.

The following comments apply to the language of the proposed law regardless of the code arrangement, and references are to the proposed sections for ready reference although revised arrangements and section numbers should be established.

2. Multiple plans

501 (e) (3) (A) refers to a trust or multiple trusts, etc., constituting parts of a plan. It is not clear whether the reference to a plan is to each plan separately or to all plans of a given type or to all plans of an employer on a consolidated basis. This problem is not important in the present law since practically all qualification requirements are under the discrimination tests set up by the regulations, etc. If the present discrimination tests are eliminated (the provisions of par. (4) are an adequate substitute since they eliminate the integration basis), it appears either necessary to (*a*) clearly indicate whether tests are to be applied to each plan or to consolidated plans, or (*b*) to eliminate the eligibility test and rely upon the discrimination test.

Generally, if an eligibility test is to be made, it should be made on each individual plan unless all of the eligibility provisions are based upon provisions of the plan rather than statistics of meeting percentage requirements. If a joint eligibility test is used, and, for example, one of the plans is modified because of union negotiations, another plan of the company may fail to qualify. It would be, for example, undesirable to have to discontinue a plan for salaried employees once it has been established because of a failure to meet a joint test in the event a union-negotiated plan were modified. On the other hand, a separate test for each plan will require more liberal, general eligibility requirements. Furthermore, a test on individual plans might cause difficulty with many employers in the event it became desirable to maintain several separate plans rather than to have one overall plan.

A specific suggestion cannot be made at this point since it is dependent upon the remaining provisions of this subsection. In general, it would be desirable, however, to limit the tests to each separate plan and to modify the other sections so as to make the tests applicable under such circumstances. In any event, it will be necessary to indicate whether tests are to be applied to individual plans or to consolidated plans if the law is to permit employers to determine whether the eligibility requirements are met without a review by the Internal Revenue Service.

3. Specific eligibility classifications

Section 501 (e) (3) (A) generally specifies the requirements for eligibility of participants in a qualified plan. Specific classifications are set up but actually they have no significance since the qualifying requirements supersede them. The list is also misleading since the specified classifications are not even acceptable unless the qualifying percentage requirement is also met. In the present law, the specified classifications do have meaning. This change is a definite limitation and would have prevented qualification of many important plans now qualified.

For example, under the present regulations, a plan limited to salaried employees of the company is a satisfactory classification regardless of the number of persons included and the percentage of key employees. For practical purposes, all of the key employees would normally be included in the salaried group. Under the proposed law, such a plan would not meet the eligibility requirements unless it included 25 percent or more of the regular employees. Many average size and large companies have sufficient hourly or union workers so that the salaried group will not meet the 25-percent test.

A specific designation of classifications independently satisfactory should be specifically set forth in the law, and these classifications should not be subject to any further limitation such as a percentage of key employees or a percentage of regular employees. The classifications should be grouped by type and carefully considered. The following is a basic suggestion:

(i) Type of compensation: Who are compensated on an annual, monthly, weekly, hourly, or other distinctive classification such as salary, wage, commissions, job incentive, or piecework or other similar classification as determined under regulations prescribed by the secretary or his delegate; or

(ii) Type of work: Who are employed as foremen, salesmen, office workers, clerical, managerial, or other distinctive group of a similar classification as determined under regulations prescribed by the secretary or his delegate; or

(iii) Location: Who are employed at any plant, division, department, operating unit, or employer: or

(iv) Bargaining recognition: Who are recognized as any separate bargaining unit.

Any plan covering all regular employees in any one or more of the foregoing classifications will meet the eligibility requirements. Employees—

(i) Who have been employed less than a minimum period not exceeding 5 years;

(ii) Who have not reached a specified age which is not more than 35;

(iii) Whose compensation is at a rate not in excess of a specified amount, not exceeding $4,000; or

(iv) Who elect not to participate in a contributory plan requiring no more than a 6-percent employee contribution.

may be excluded from any classification without affecting the qualifications. No further percentage requirements should be made applicable to this group.

4. Basic compensation rate exclusion

Section 501 (e) (3) (A) (iv) provides that employees who are compensated at an annual rate in excess of a specified amount which does not exceed $4,000 may be excluded in any type of plan rather than only in a pension plan integrated with social security. The $4,000 is arbitrary and apparently has been determined as a matter of policy. The present law provides for the exclusion in a pension plan of employees earning less than an amount considered as the maximum under the social-security law, and, by regulations through the integration procedures, has permitted exclusion of employees at higher amounts so long as the benefits were integrated with social security.

If, as a matter of policy, it is desired to exclude employees under a given rate of compensation irrespective of the integration requirements, the amount then becomes a matter of policy or a measure of discrimination. The provision and

the level of exclusion will have to be determined by Congress taking into account all of the practical considerations after a review of the testimony.

In any event, however, in order not to discriminate against integrated plans possible under the present law, the provision for excluding benefits for employees earning less than an amount related to social-security benefits should be reinstated at least as an alternative possibility, for pension plans integrated either arbitrarily or automatically with social-security benefits. The limitation should specifically provide that any amount is satisfactory so long as the resulting benefits are within the integration limitation of social security as from time to time amended.

While fundamentally, it might be desirable to draft a simple provision for determining eligibility of a plan, it should not be necessary for plans to meet the simple test if a more satisfactory and proven test is available. The so-called social-security wage basis should specifically be included at least as a possible alternative basis for determining eligibility in integrated pension plans. Many large plans are now qualified by excluding employees earning less than amounts in excess of the proposed $4,000 figure. These plans, however, have been qualified on the basis of the fact that the benefits do not exceed those permitted under the integration discrimination provisions. It is necessary that such a provision continue so as to protect existing plans when amendments are required in the future.

5. Age exclusion

Section 501 (e) (3) (A) (v) permits the exclusion of employees who are not more than age 35. Since many plans use age nearest birthday, it might be desirable to revise this language so as to indicate an age not more than 35½ years or perhaps a still better procedure would be to refer to an age under 36. The age exclusion should not be a separate classification along with type of work, plant, division, etc., but should be an overall limitation applicable to the employees of any other qualified classification.

6. Other classifications

Section 501 (e) (3) (A) (vii) provides for a qualification under any classification set up by the employer subject to certain percentage limitations. This provision differs from that in the present law which limits the other classifications to those found by the Commissioner not to be discriminatory without any further qualifications as to percentages, etc.

The theory of the revised language would perhaps permit certain employers to determine without the approval of the Secretary, whether or not the specific tests have been met. The specific tests, however, are difficult to determine as will be indicated in a later section. The Secretary, however, would have no power to qualify an integrated pension plan.

On the other hand, in order not to discriminate against employers having or desiring an automatically integrated plan, it would be necessary to at least permit an alternative provision permitting other classifications set up by the employer which do not result in discrimination as determined by the Secretary or his delegate. This alternative provision is rather important since there are hundreds of plans, including many negotiated plans, providing for an automatic integration with social security and resulting in a classification which in many instances would not meet the percentage requirements. It is undesirable to require a taxpayer to maintain the necessary records to make the quarterly percentage check, and it is certainly inequitable to cause plans of an automatic integrated type to become disqualified because of the peculiarities of the arbitrary percentage requirements.

7. Employee contributions

Section 501 (e) (3) (A) (viii). An additional classification should be added so as to exclude employees electing not to participate in a contributory plan if the classification otherwise meets the requirements, and if the required employee contribtuion does not exceed 6 percent of the basic or total compensation as considered in the plan.

Such a provision will eliminate the necessity of the continual concern over qualification of plans in the event employees do not elect to participate. If the contribution is limited to a reasonable amount such as 6 percent, the plan should be permitted to continue to qualify even though employees elect not to participate. The classification should be determined by the employer and should be certain thereafter of whether or not employees individually elect to participate or not.

8. Stockholder limitation

Section 501 (e) (3) (A) provides a so-called 30 percent stockholder limitation in the law. This limitation is not in the present law; it arises in a regulation and has been overruled in certain courts.

If a so-called stockholders' rule is desired as a matter of policy, the limitation should apply, irrespective of whether the 25 percent or alternative test is met. It would be inequitable to limit the benefits to stockholders if the percentage test is not met and to eliminate it if the percentage test is met. For example, a corporation with 4 employees, 2 of whom are stockholders, could provide a plan for the 2 stockholders by meeting the percentage requirements and thus avoid the stockholder rule; whereas a company with 100 employees, and including 20 of them under a classification rule would limit the stockholders. This difficulty arises with the percentage rule rather than the stockholder rule although it does illustrate the inequality of the stockholder rule.

As a matter of fundamental principle, the stockholder rule is inequitable since it limits the contributions to a percentage of the total number of employees and thus discriminates between various size groups. Furthermore, it also discriminates against a person who happens to own stock in one corporation as related to a similar person in another corporation with less stock. It would appear that the most satisfactory test for the stockholder would be the reasonableness of compensation under other sections of the law. If benefits are permitted under the deferred compensation plan for a person who owns 9 percent of the stock, a person owning 10 percent in the same circumstances should not be discriminated against.

9. Percentage requirement

Section 501 (e) (3) (A) provides generally that if 25 percent or more of all of the regular employees are included in the plan, the plan is not discriminatory regardless of the classification. This limitation is not coupled with a benefit limitation as under the present law through integration. In effect, therefore, the proposed law is more liberal in that it permits any possible classification without limitation on benefits so long as the 25 percent test is met.

The 25 percent test is difficult to determine because of the changing employees from day to day and the changing of the employees meeting the various eligibility requirements. The determination is difficult, the administrative work required is unnecessarily complex, the penalty for technically not complying is serious, especially when compliance may be beyond the control of the employer, and in general a percentage limitation is discriminatory against similar employees in diff›rent sized employers.

Under the proposed language, a small company with 4 employees could arbitrarily include 2 employees, meet the eligibility requirements and have no limitation on the amount of benefits payable under a pension plan. A reasonably satisfactory limitation is available in a profit sharing type of plan because of the limits on the deductibility of contributions, although even in this case certain manipulations would be possible.

An eligibility test, to be practical and satisfactory, must be determined on conditions which can be specified in the plan and which are automatically met at all times by virtue of the provisions themselves such as all employees compensated on a salary basis.

10. Quarterly determination

Section 501 (e) (3) (A) provides that in determining the percentages for purposes of qualifying a plan, it is necessary to prove that at least 1 day in each quarter, the tests were met. Similar language exists under the present law. On the other hand, since, under the present law, practically all of the determinations have been made by the Commissioner on the basis of discrimination, practically no one was required to meet this test. If the determination under the proposed law eliminates the approval of the Commissioner as a basic test of qualification, (which test incidentally is a continuing one and not subject to automatic termination) it will become necessary for employers to maintain records and to apply the tests each quarter and be subject to the possibility of automatic disqualification for causes beyond their control in many cases which cannot be known until after the condition has occurred.

If a percentage requirement is continued in the law, the test should be made annually on the anniversary date each year upon which the valuation or eligibility is determined. Provision should also be made for a period of modification so as to permit the employer to continue on a qualified basis even though technically conditions have temporarily caused a failure to meet the percentage requirement.

No precedent has been established for this type of provision. Obviously, the most satisfactory provision is one of the type used in the present law permitting an employer to obtain an approval which continues in effect without the necessity of jeopardizing the qualification of the plan because of changes in percentages of types of employees frequently beyond the control of the employer.

11. Key employee limitation

Section 501 (e) (3) (A) provides a key employee limitation Standing by itself, the limitation would require the inclusion of all regular employees in order to meet the requirement for qualification if all of the key employees are to be included in the plan. It does not seem desirable to indicate that certain lower compensated employees can be excluded if a key employee is also excluded. The 10 percent test, as limited in the definition to 100 employees, in the key classification permits larger companies to operate on a satisfactory basis, but unduly discriminates against the average sized company. It would appear that an employer of 100 or 500 or 1,000 employees should have the same flexibility of establishing a plan as one with 100,000 employees.

The key employee test will permit plans for union employees and other lower compensated employee groups if the key employees are not included. While this may meet certain requirements of certain companies, it does impose a limitation for most employers desiring plans including key employees. If for any reason, one of the lower compensated employees has to be excluded, such as for example, because of negotiations with a union, the employer cannot cover all of his key employees. Furthermore, if the union has a separate plan, a plan for salaried employees obviously could never meet this test and provide benefits for key employees. The provision is therefore discriminatory in that, if in a given company, all of the employees are included in one plan, benefits can be provided for all key employees, while if in another company, for some reason a separate plan is required for union employees for example, or the union employees through negotiations have determined no plan is desirable, the salaried employees and the key employees cannot obtain benefits.

The tests relating to key employees should be completely eliminated from the eligibility requirement provisions.

12. Definitions

Section 501 (e) (3) (B) provides definitions of the certain words used in paragraph (A). These definitions will, of course, need to be modified to be consistent with the necessary adjustments in paragraph (A) as previously commented upon.

In general, the definitions should be included as a separate subsection since the definitions should be made applicable to all of the paragraphs in the section 501 (e). It is desirable also to include definitions of a plan as distinguished from plans, and employer as distinguished from employers, and a clear-cut definition of a pension as distinguished from a profit-sharing plan. Since the treatment of pension and profit-sharing plans is different in some respects under the proposed law, the partial definitions in the existing regulations are not sufficiently complete. In order to permit an employer to interpret the law, specific definitions should be included in the law itself

13 Key employee definition

Section 501 (e) (3) (B) (ii) defines key employees as "those employees whose total compensation places them in the highest paid 10 percent of the regular employees of the employer" (maximum 100) and thereby creates an inequitable classification difficult or impossible of definite determination.

Any regulation explaining this condition would have to be involved and require considerable detail work for the taxpayer or be quite arbitrary. Tests are required on 1 day in each quarter of each taxable year. If total compensation means a rate of compensation on the day each quarterly test is made, the determination becomes impossible if commission, bonuses, or other deferred or year end adjustments exist. If it means the actual earnings for the previous year immediately prior to the date of the quarterly test, a calculation will be required each quarter and the individuals included may vary widely from quarter to quarter, if year end bonuses or adjustments are made. Normally, information on compensation is not available on the day of the test so that a plan may be disqualified before the facts are known and no provision for adjustment is made.

Furthermore, the determination of the number of regular employees of the employer at each quarter becomes difficult and requires additional work for the

taxpayer since the definition of regular employee for this purpose does not coincide with the other records maintained quarterly.

The law should be revised so as to make it unnecessary to have to define a key employee.

14. Participant definition

Section 501 (e) (3) (B) (iii) defines participants as including only those employees in a classification set up by the employer who, if they remained employees of the employer at the current rate of compensation until normal retirement age, would be entitled to receive full benefits under the plan.

Reference is made to a classification set up by the employer. It should presumably be limited to the classification of employees covered by the plan.

Provision should be made for situations in which credit is given beyond normal retirement age and employees will qualify at a date later than the basic normal retirement age in the plan. Perhaps this might be modified by adding "or such later age required to qualify for benefits" after the words "normal retirement age."

It will be necessary to define "full" benefits under the plan. For example, many plans provide for reduced benefits during the first years of participation in the plan for all employees. Other employees may receive reduced benefits because of the election of a joint option. Benefits may vary with social security or may be reduced by workmen's compensation or other payments so that, in effect, full benefits are not available under the plan if "full benefits" is interpreted to mean the benefits determined by the formula in the plan. In many plans, employees with short service are eligible only to receive a portion of the basic benefit at retirement.

A more satisfactory definition will be required in order to administer the plan without the necessity of issuing detailed regulations. The most satisfactory answer would be to eliminate the need for such a definition by changing the eligibility requirements.

15. Regular employee definition

Section 501 (e) (3) (B) (iv) defines regular employees. Since employees fluctuate from day to day, the determination of the number of regular employees becomes administratively difficult.

The years of service exclusion is that provided by the plan, not to exceed 5 years Many plans provide for an eligibility once a year following the completion of 5 years of service. In this case, actually employees are excluded from the plan, in some cases, up to 1 day less than 6 years of service. If tests are made at the beginning of the year, the 5-year requirement may be satisfactory. If tests are made during or at the end of the year, the 5-year provision may cause inequalities in applying the tests in certain plans.

A peculiar problem arises in attempting to apply the definition of regular employee in a company having more than one plan with different eligibility requirements. If tests are made separately on each plan, it would be possible to have two different definitions of regular employees, one for each plan. If the discrimination tests, however, are to be applied jointly to all plans of the employer, the definition is incomplete and no satisfactory basis is possible.

Temporary and seasonal employees are arbitrarily defined. Many plans use the designation "temporary" or "seasonal" employees based upon company classifications which may be different from the arbitrary one set forth in the proposed language. In order to apply the test, it will be necessary, in these cases, to make a separate arbitrary determination for purposes of the law. This would involve added administrative work, and might cause disqualification in cases where definitions in company plans differ from the arbitrary specifications in the law.

The most satisfactory solution to this problem is, of course, to revise the discriminatory classifications so as to make it unnecessary to determine regular employees for purposes of the test.

16. Types of pension plans

Section 501 (e) (4) (A) refers to a pension or annuity plan. There are no definitions of pension or annuity plan in the revised law. The definitions in the existing regulations under the present law are inadequate to distinguish between a pension and a profit sharing plan to the extent necessary under the proposed law. Furthermore, the proposed law creates new problems necessitating a distinction as to the forms of benefits regardless of the type of plan.

From a tax point of view, it would be desirable to have separate plans for each type so that the limitations could be applied simply under the provisions of the code. Practically, however, many plans will include aspects of both pension and profit-sharing types of provisions. This is perhaps particularly true of plans including insurance contracts where the benefits are rigidly determined by the insurance contracts. In trusts, it would be generally easier to make the segregation, although it is perhaps desirable in many cases to have benefits paid out of certain reserves.

Tests should be applied to the particular types of benefits rather than to the plan meeting definitions of pension or profit sharing. Such a procedure would be more consistent with the plans as they exist today and are likely to continue in the future. If the tests are applied to the benefits in plans rather than to the types of plans themselves, it will still be necessary to provide specific definitions in the law for this purpose.

17. Contributions versus benefits

Section 501 (e) (4) (A) bases the test upon whether contributions or benefits under the plan are discriminatory. The language in the present laws is similar except that it is applicable to all plans including pension and profit-sharing types. In the context of the present law and regulations, the contributions are used as the test in profit-sharing type plans, and the benefits are used in the pension type plans. Both tests cannot be met at the same time in any pension plan.

It would appear desirable to define a pension plan as one providing benefits determined by a formula in the plan based on factors other than contributions, the costs of which are determined actuarially. In this case, the test in this section should be limited to benefits under the pension or annuity plan, since contributions are obviously always discriminatory because of age differences, etc. So-called money purchase plans would be classified as accumulation plans and profit sharing tests would apply.

The present language could be interpreted as meaning that either the contributions or the benefits do not bear a higher ratio, etc., whereas actually the test must be applied only to the benefits in a pension or annuity plan.

It will also be necessary to define the meaning of benefits for the type of test under consideration. The present law leaves the determination of discrimination to the Commissioner. Regulations have been prescribed to cover all of the various types of benefits under the present integration type of discrimination. If the integration basis for discrimination is eliminated from the law, as the proposed code does, it will be necessary to indicate the basis of determining benefits for the purpose of the arbitrary test in the law itself. Benefits may be expressed in terms of monthly life annuities at normal retirement age, at actual retirement, or in the event of disability retirement. The amounts and the values are different in most plans. It would also be necessary to determine whether consideration should be given to collateral benefits such as guaranties for periods certain after retirement, vesting in the event of termination or death prior to retirement, additional benefits upon death either before or after retirement either in the form of added cash payments or annuities to widows or dependents.

Benefits for this purpose might be determined on the basis of the actuarial value at normal retirement. Even this, however, would need additional modification because the value of somes of the benefits under certain plans will be consumed from year to year during the operation of the plan on an insurance basis in the case of certain death benefits, disability benefits, widow's benefits, in excess of the reserve available at the time from the determination of the retirement benefit value.

Obviously, special consideration will also need to be given to determining the relative benefits in plans requiring employee contributions. Under the present regulations, the discriminatory test is based upon the benefits available from employer contributions only.

Perhaps the most satisfactory suggestion would be to recognize the fact that pension plans require an actuarial determination to ascertain the costs. Consequently, either an arbitrary, but determinable, basis of describing benefits by a formula, with or without specific adjustments for the important variations such as length of service, average earnings during last 5 years of service, etc., should be prescribed; or a basis such as integration with social security or some other arbitrary basis providing a specific basis for an actuarial determination, as determined by the Secretary should be established.

18. Discrimination ratio

Section 501 (e) (4) (A) providing that the basic test of discrimination in a pension plan is that benefits do not bear a higher ratio to the compensation for any covered employee than for any other covered employee whose compension is lower, is satisfactory only if certain conditions now in present regulations are preserved. Additional provisions are therefore necessary under the proposed language in order to clearly indicate to the taxpayer a basis for such a determination and to provide a reasonable basis for plans of the pension type.

The present law refers only to discrimination in favor of higher compensated employees. The regulations, based upon the integration with social-security theory permitted limited plans and variations in benefits based upon limited compensation and social-security differentials. A substantive basis was therefore provided to be used as a basis of administration.

The proposed language, however, does not provide any substantive basis but rather an arbitrary and inadequate standard based upon the limited words in the law. The precedents established under the old integration regulations presumably could not be used. Under these circumstances, the language in the law must be more specific so as not to be interpreted more strictly than the present regulations, and disqualify all integrated plans.

The test in the new code language would apparently be required for every employee in the plan. Under these circumstances, practically no unit benefit plan would qualify since there would always be certain lower compensated individuals who would receive lower benefits in relation to compensation than some of the higher paid individuals, because of the pure chance of age of employment and service at retirement. It would obviously be necessary to take service into consideration as well as rate of compensation to meet this particular requirement.

For this purpose, it will be necessary to define compensation in more detail than is provided in the paragraph following paragraph (B) in this section. Many pension plans base the benefit formula on the average earnings during the last 5 years of service or the last 10 years of service, or the earnings following the effective date of the plan. If compensation is defined as that at the time of any test, or at the time of retirement, there obviously will be individuals who will violate the specific test proposed in the revised language.

For this purpose, compensation should be the compensation considered under the plan for determining benefits rather than the compensation of the individual so as to avoid disqualifying plans providing benefit credits during periods of leave of absence for military service, sickness and so forth.

It would appear more satisfactory to provide as a test for discrimination in a pension plan, some uniform formula based upon age, service and earnings rather than to attempt to set up a test based upon a determination for individual employees.

19. Integration test

Section 501 (e) (4) (A) attempts to provide an approximate equivalent of the present integration basis by permitting a deduction up to the first $4,000 of annual compensation. If the other problems in this section can be met, the right to exclude up to the first $4,000 in determining the benefit ratio, would satisfactorily meet the present integration limitation in certain simple basic types of plans. The $4,000 exception, however, would provide an immediate and definite limitation over that available under the present law and regulations. Under the present law, discrimination is measured by the equivalent of a percentage up to 150 percent of the social-security benefit depending upon the provisions of the plan. In these cases, a different type of test is required since a constant compensation deduction would have to be raised considerably above $4,000 to provide a satisfactory basis for such plans. It does not appear desirable to materially increase the $4,000 exception, so that the only practically satisfactory answer is to provide a different type of test for pension plans.

If social security is amended as is now being proposed in Congress, the $4,000 limitation would immediately cause a restriction over the basis provided in the present law because of the change to $4,200 for social-security purposes. Furthermore, the specific $4,000 exclusion test would, for practical purposes, make it impossible to provide an integrated plan in the future even though an employer deems such a plan necessary or desirable because the plan would automatically be disqualified under the arbitrary test if social security was amended.

It is satisfactory to have a simple, arbitrary alternative for those who might wish to adopt a plan based upon the specific arbitrary provisions of the law

if Congress so desires. It would appear, however, necessary to provide at least an alternative for those employers who feel it necessary or desirable to have plans integrated with social security. Incidentally, hundreds of plans negotiated with unions are automatically integrated plans to some extent at least.

20. Profit-Sharing Plans

Section 501 (e) (4) (B). The suggested provisions raise certain problems. The language, however, does permit some recognition to be given to past service or other factors such as merit, etc. The tests in a profit-sharing plan are much more direct than in a pension plan since they can be applied to the contribution, income, and forfeitures each year. The general test for this purpose therefore appears to be satisfactory although the exact formula for limiting distribution requires some consideration. It is assumed, however, that the profit-sharing organizations will present testimony as to the specific factors to be considered for this purpose.

21. Alternative tests

Section 501 (e) (3) and (4). Consideration might be given to the possibility of adding an additional combination of circumstances of eligibility and discrimination so as to permit, in effect, any classification whatsoever set up by the employer, provided the total benefits to employees of an employer under a profit-sharing plan do not exceed those possible by a 15 percent contribution, and the total pension benefits from all plans of the employer would not exceed a benefit such as, for example, a life annuity beginning at age 65 of 2 percent of the average compensation considered under the plan during the last 5 years prior to retirement, for each year of service, and providing that the vesting on separation or death or for lump-sum payment purposes after retirement were limited to one-tenth of the reserve required to provide such benefit at the time for each year of participation in the plan.

This type of provision would eliminate the problems arising out of a discriminatory classification and yet would place some reasonable limitation on the benefits in the form of a simple stated formula rather than a relation to integration under social security.

The effect of such a provision would be merely to recognize that within the specific prescribed reasonable limits an employer would have freedom to determine whether a portion of the compensation of any individual should be deferred or paid currently, and would reasonably protect the Treasury against manipulation and substantive loss of taxes.

Incidentally, if such a provision were agreed upon, it could also be used as a basis for providing a deferment of taxes for self-employed, for individual employers, and for partners.

It is believed that such a provision would, if properly qualified, eliminate practically all of the difficulties of the present and proposed law with respect to qualification and discrimination.

22. Definitions

Section 501 (e) (4) definitions following subparagraph (B). The definition of compensation should be moved to the general section on definitions or at least made part of subparagraph (B) applicable to profit-sharing plans only since, as indicated above, a different basis is required for pension plans. The definition itself should also be clarified to indicate that the compensation considered for this purpose is compensation as defined under the plan which may be basic, regular, or total compensation as desired.

23. Multiple plans

Section 501 (e) (4) last sentence provides that the test be applied separately to any classification in paragraph (3). This should be clarified to apply to any plan rather than classification, and should be coordinated with the language at the beginning of pragraph (3) (A).

It will be necessary to specifically indicate the basis to be used for applying the discrimination test in case more than one plan is in existence by an employer or group of employers. The test in the last sentence of this paragraph (4) is inadequate to provide for instances in which an employer has more than one pension plan or has a pension plan and a profit-sharing plan covering some or all of the same employees.

It will be necessary to consider the benefits under other plans in order to provide a satisfactory test so as to permit the continuance of a general practice now

in existence of using integrated benefits in at least one of the plans. The exact manner of applying the test will depend upon the provisions setting up the eligibility requirements and the basis for discrimination as provided in both paragraphs (3) and (4).

24. General exceptions

Section 501 (e) last paragraph following paragraph (4) provides general exceptions. These should perhaps have a separate paragraph designation with a caption. In general, the three provisions are satisfactory although perhaps others should be added when the necessary changes to meet the problems in the other sections have been completed. In any event, the reference to profit-sharing plans should be eliminated in the first and third items so that the provisions will apply to all types of plans and not be limited to profit-sharing plans.

MISCELLANEOUS

1. Tax to beneficiary

Section 401 applies to employee annuities and other deferred compensation and section 402 applies to both qualified and nonqualified employees trusts. These sections overlap, are confusing, and provide certain differences between insured and trust programs.

Other deferred compensation in section 401 should be treated the same as a nonqualified trust in section 402.

One section covering all distributions under all deferred-payment plans would be desirable. The same provisions could then clearly be applicable to all situations without confusion.

2. Investments

Section 505 provides limitations on investments similar to those in the present supplement Q, but more restrictive. It is desirable to provide a specific basis for securities of the employer. There may be some advantage in providing for some diversification of securities.

In any event, however, if an investment limitation is to be imposed on deferred payment trusts, in order to be practical it must provide that the requirements are to be met only at the time of investment of funds and that the limitation should not apply to any one investment of less than $10,000 so as to provide for the small trust, and reports should be required, if at all, only annually at the time the tax year ends.

3. Returns

Section 6033 requires exempt deferred payment trusts to file special returns. It would be desirable to provide an exception, as exists in the present law, making it unnecessary to file if the employer files the information required to support deductions for contributions to such plans.

4. Miscellaneous

Sections 38, 72, 101, 402, 501, 503, and 504 included related subjects and will need editing depending upon the changes previously suggested under sections 403 and 501 (e). Generally, these items cannot be determined until the sections 403 and 501 (e) problems are solved, so comments are omitted at this time. The necessary changes will normally be only those required to make these sections consistent with the revised provisions of sections 403 and 501 (e).

Additional information is available and can be supplied as supplementary exhibits.

STATEMENT OF JOHN C. MCCART, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES

Our federation desires to comment on section 38 of H. R. 8300 in the interest of employees in the Federal civil service and the service of the Government of the District of Columbia.

These are employees provided with an annuity under the provisions of the Civil Service Retirement Act. Our remarks will be directed specifically to the interest of these employees although we concur in the argument that other public-service employees should benefit similarly.

The annuity which a civil-service employee receives upon his retirement from active service is a relatively small amount. For this and other reasons it should be exempted from income tax and other tax levies which will reduce it still further.

The removal of liability for taxation might well be open to some question if it were a case of providing a special group with a special privilege which would relieve the members of that group from paying out in taxes sums of money which would provide them with luxuries. However, that is certainly not true of civil-service retirement annuity.

In the fiscal year ending June 30, 1952, the average Federal civil-service annuity was $1,188. Expressed in terms of the 1939 dollar, this average annuity has the buying power today of $620. Fifty percent of the number of persons at present on the retirement rolls are receiving this amount. Of the total number of annuitants, 75 percent are receiving less than $1,560 a year. This amount is equal to $800 in 1939 purchasing power. In other words, three-fourths of the 176,330 persons who were receiving a Federal civil-service annuity on June 30, 1952, were being paid less than $1,560. Of the 39,902 survivor annuitants, 99 percent were receiving an annuity below $1,560. It may be noted in passing that approximately 60 percent of the total number of employee annuitants were receiving an annuity because of disability, involuntary separation by reason of reduction in force, or for having reached the mandatory age of 70.

These figures emphasize two points: (1) The sum paid the individual is small; and (2) the annuity received in the majority of instances makes it possible for the individual just to get by. When we consider figures such as these, we are in reality concerned with subsistence living. The amount involved is small even in relation to today's income figures, and when we realize that in proportion to the amount of goods and services these annuities could buy at prewar prices, they represent even smaller sums.

Our purpose in referring to the depletion of the value of annuities by the rise in living costs is to emphasize the fact that we are concerned with small annuity payments which would provide a relatively low tax payment, and in many cases no tax liability whatever. However, in view of the small incomes these annuities provide, even a small amount of tax would be large in proportion to the annuity and in proportion to the demands upon that income. It is a question of personal hardship for persons who in the majority of instances are advanced in years and are depending upon their annuity income for subsistence and shelter as well as for medical care. In every case, the annuity represents a substantial reduction of income.

Under existing income-tax policy, the recipient of an annuity, pension, or retirement check is allowed to recover tax-free whatever investment he has made, that is, without any obligation to pay an income tax on the annuity payment equal to his investment. Once the sum of these payments equals the amount the annuitant has invested, he has full tax liabiltiy on all annuity payments thereafter, subject, of course, to exemptions on deductions for other reasons. If an annuity, pension, or retirement plan contains no capital of the taxpayer, all payments are taxable, unless they are excepted by law. This exception by law is at present provided for Government pensions to veterans or their families, social-security benefits, and railroad-retirement pensions. It should be noted that, while in some cases civil-service annuities exceed social-security benefits, the individual employee makes a larger contribution. Six percent is deducted from his annual salary or wage and it is estimated that the average retired employee has through his contributions paid for 15 percent of the costs of his annuity.

The social-security law was passed when the country was suffering from a severe economic depression. The amount of payment involved was small and it was therefore exempted from all legal demands upon it, to guarantee to the individual the receipt of the entire amount due him. We believe that the same reasoning which was applied to social-security benefits and to those provided under the Railroad Retirement Act should be applied to the annuities provided employees in the public service.

By way of summary, the problem with which we are dealing here is one of attempting to provide a very modest income for persons who have served their Government well. If they are receiving even the low average annuity, it means that they have an appreciable amount of service. To maintain the continuity of our Government operations, it is imperative that we must have at least the basis for a career service. The Federal Government has a high rate of turnover of personnel, and the turnover rate should be reduced for the sake of efficiency and sound operation of government. It can be reduced only if the Government has a few advantages to offer, one of which is a retirement annuity which would be a little better than the individual could purchase commercially. It still will be

small enough that no one need to be greatly upset and considerably worried because a Government employee is singled out for preferred treatment.

When 80 percent of the annuitants receive less than $2,000, and that after a considerable period of service, it should be evident that there is no opportunity for luxurious living. We are dealing with subsistence living and it seems desirable to remove the possibility of taxation from the smaller amounts received. It is imperative that we give these employees some assurance that they will be relieved of extreme want in later years when they are no longer able to provide for themselves.

DISTILLED SPIRITS INSTITUTE, INC.,
Washington 4, D. C., April 23, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Section 5008 of H. R. 8300, now pending before your committee, contains provisions which discriminate against the users of distilled spirits strip stamps and constitute a levy against the distilled spirits industry which is not exacted of any other industry required to use similar internal-revenue stamps. This comes about because subsections (a) (3) and (b) (3) provide for the furnishing of distilled spirits stamps by the Government at an exorbitant profit, whereas tobacco strip stamps (sec. 5703 (b)) and beer stamps (sec. 5055) are to be furnished at the cost of preparation, and wine stamps (sec. 5368 (b)) are to be furnished without cost.

The report of the Committee on Ways and Means states that many substantive changes in the Internal Revenue Code have been made "to remove inequities." The provisions as to strip stamps, however, create an inequity which should be removed.

The statute requires that strip stamps be affixed to bottles containing distilled spirits, and provides that such stamps shall be sold to persons entitled thereto at a cost of 1 cent for each stamp, except in the case of stamps for containers of less than one-half pint, which shall be sold for one-quarter of 1 cent for each stamp. It may be that the discrimination occurred through inadvertence in the process of writing new provisions of law to provide for the payment of tobacco, wine, beer, and distilled spirits taxes by return. Nevertheless, the inadvertence will result in payment by the distilled spirits industry of a premium of several millions of dollars annually for stamps for distilled spirits, while similar stamps will be sold to the tobacco and beer industries for a sum sufficient only to defray the cost of preparation thereof, and will be furnished free of cost to the wine industry.

The annual report of the Commissioner of Internal Revenue for the fiscal year ended June 30, 1952, shows the quantity of distilled spirits strip stamps shipped to collectors, but not the quantity actually sold to users. According to figures on use of stamps compiled by this office it appears that the number of distilled spirits strip stamps so sold was approximately 1,375,722,126. From the best information available to us it appears that the cost to the Government of printing the bottled-in-bond stamps (by engraved plate process) is $1.54 per thousand and the cost of printing the red strip stamps (by the offset process) is 25 cents per thousand. These stamps cost the Government $519,404 to produce, and were sold to users for $13,364,947, i. e., a sum equal to 26 times the cost of production.

During the fiscal year 1952 over 21 billion stamps were furnished to the tobacco industry for use on tobacco products, and more than 110 million stamps were furnished to the beer and wine industries. Under the provisions of the proposed Internal Revenue Code of 1954, these stamps will be furnished to the tobacco and beer industries at the cost of preparation, and free of cost to the wine industry, while the distilled spirits industry will be required to purchase its stamps at a price representing 2,600 percent of the cost of preparation.

Two types of strip stamps are used on bottled distilled spirits: (1) strip stamps for bottled-in-bond spirits, and (2) strip stamps for other distilled spirits for domestic use. These stamps are not money-value stamps in the sense that they represent the amount of tax paid, but are designed and intended only for the purpose of authenticating the package, i. e., as an enforcement measure. Evidencing such purpose is the statement contained in the report of the Committee on Finance of the Senate to accompany the Liquor Taxing Act of 1934, which first provided that strip stamps be affixed to containers of distilled spirits not bottled

in bond. In speaking of title II of the bill, which contained the strip-stamp provisions, the following statement was made in the report:

"Its primary purpose is to protect the Federal revenue by supplying a simple and immediate means of ascertaining whether any particular distilled spirits have been legally produced and the tax paid thereon.

"Its second purpose is to give the consumer a means of knowing that he is purchasing legally produced and tax-paid distilled spirits.

"Its third purpose is to afford an assurance that distilled spirits after the payment of tax thereon will not be mixed in the rectifying process with illegally produced spirits. The issuance to the rectifier of the requisite tax stamps will afford a substantial additional check on the rectifier's account showing the amount of distilled spirits purchased and sold by him.

"This amendment does not in any manner affect the substantive question of how distilled spirits shall be handled or sold or in what type of container they shall be sold. It merely provides that in whatever manner and in whatever container distilled spirits may from time to time be handled or sold, such distilled spirits shall bear a stamp, indicating the payment of all internal-revenue taxes levied thereon."

Similarly, the Bottled-In-Bond Act of March 3, 1897, which first authorized the bottling of distilled spirits in bond and required that a strip stamp be affixed to each bottle, was enacted for the purpose of protecting the consumer. The Committee on Ways and Means, in its report on the Bottled-In-Bond Act, stated the purpose of the bill to be as follows:

"The obvious purpose of the measure is to allow the bottling of spirits under such circumstances and supervision as will give assurance to all purchasers of the purity of the article purchased, and the machinery devised for accomplishing this make it apparent that this object will certainly be accomplished."

Under the provisions of the proposed Internal Revenue Code of 1954, the tobacco, beer, and wine stamps will serve the same purpose as the distilled spirits strip stamps, i. e., authentication of the product and protection of the revenue.

It should be borne in mind that the price paid to the Government for these stamps is not the only element of cost involved in affixing the strip stamps to bottles of distilled spirits. It is estimated that it costs approximately one-fourth cent each in labor and other elements of cost to prepare and affix the stamps to bottles. In the interest of enforcement and as an aid in the fight against illicit liquor, the legal industry is anxious to make every necessary contribution. However, we do not feel that a tax should be levied upon efforts and measures designed to enforce the law.

The provisions relating to the method of taxpayment of distilled spirits, wine, beer, and tobacco have been made uniform in the proposed Internal Revenue Code of 1954. We believe that these industries should likewise be accorded uniform treatment with respect to the cost of all nonvalue stamps evidencing that their respective products have been legally produced and that the tax has been determined. The loss of a relatively small amount of revenue to result from according this industry equitable treatment in respect of its purchases of strip stamps should not be determinative.

Our position in this matter has been formally presented to officials of the Treasury Department who have expressed sympathy with our viewpoint. They will undoubtedly consult with your committee regarding the matter.

We, therefore, earnestly request that subsections (a) (3) and (b) (3) of section 5008 of the bill be amended to provide that distilled spirits strip stamps shall be sold at a sum sufficient to defray the expense of preparation, as in the case of tobacco and beer stamps.

Respectfully submitted,

HOWARD T. JONES, *Executive Secretary.*

WINE INSTITUTE,
San Francisco 3, Calif., April 23, 1954.

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

MY DEAR SENATOR MILLIKIN: This letter is in support of the provisions of H. R. 8300, insofar as it relates to the production of wine under the revenue laws, and as it was passed by the House of Representatives.

It is also in support of four technical or clarifying amendments of a minor nature with regard to wine which have been discussed by the Treasury Depart-

ment with wine industry representatives and which we understand will be submitted to your committee by the Treasury Department. These four minor amendments relate to sections 5373, 5383, 5384, and 5387.

For many years, the provisions of the revenue laws relating to the technical aspects of wine production and its supervision by revenue officers have been badly in need of revision. Since 1947, the wine industry has been working with representatives of the Revenue Service in the preparation of practical revisions which would (1) simplify operations both from the Government's standpoint and the point of view of the winery proprietors, and (2) maintain and improve the standards for wine as recognided in good commercial practice.

These industry efforts on a nationwide basis were carried on through the Wine Conference of America, which is composed of the 20 principal wine associations in the United States, and which represents through its respective memberships about 95 percent of the wine sold in this country.

The efforts of the conference were summarized in two identical bills (H. R. 2065 and H. R. 2066), intrôduced last year by the Honorable Leroy Johnson, of California, and the Honorable W. Sterling Cole, of New York, respectively.

Practically all features of our proposed legislation were incorporated by the Treasury Department in the draft of H. R. 8300 which it submitted to the Committee on Ways and Means. These provisions were endorsed by the Wine Conference of America in a letter dated February 10, 1954, submitted to the Honorable Daniel A. Reed, chairman of the Committee on Ways and Means, when the bill was pending before his committee.

We sincerely hope that the wine provisions of H. R. 8300 will have the concurrence of your committee, and that the four amendments to be proposed by the Treasury Department will be acceptable both to your committee and to the managers on the part of the House when the bill goes to conference.

Our hearty endorsement of the operating provisions of H. R. 8300 is, of course, separate and apart from any question of actual excise rates. On the question of wine excise rates we hope to be able to present our position at an appropriate time when your committee is considering these matters as such.

It would be very much appreciated if this letter, and attachment listing the 20 member associations of the Wine Conference of America, could be made a part of the record on H. R. 8300.

With very best regards.

Sincerely yours,

EDWARD W. WOOTTON,
Manager, Washington Office, Wine Institute, and Secretary, Wine Conference of America.

MEMBER ASSOCIATIONS OF THE WINE CONFERENCE OF AMERICA

American Wine Association
Associated Vintners of the Middle West
Bottle Fermented Champagne Producers, Inc.
Council Bluffs Grape Growers Association
Finger Lakes Wine Growers Association
Maryland Institute of Wine & Spirits Distributors, Inc.
Michigan Wine Institute
National Association of Alcoholic Beverage Importers, Inc.
National Wine Association
New Jersey Wine Association
Ohio Grape Growers & Vintners
Ohio Grape Growers Institute
Ohio Wine Dealers Association
North Carolina Association for Wine Control
Texas Wine Association
Vermouth Institute
Washington Wine Council
Wine Association of Pennsylvania
Wine Distributors of Northern California
Wine Institute

STATEMENT BY THE COMMITTEE ON TAXATION OF THE UNITED STATES COUNCIL OF THE INTERNATIONAL CHAMBER OF COMMERCE

1. The purpose of this statement is to acquaint the Senate Committee on Finance with the views of the committee on taxation of the United States council of the International Chamber of Commerce on the subject of taxation of foreign income.

The United States council is the American national affiliate and the official representative of American business in the International Chamber of Commerce. The council's membership is composed of about 700 companies in all industries in the United States, many of which are not engaged specifically in international trade or the import-export business.

The International Chamber of Commerce was organized in 1919 following World War I. It might be regarded as a world business parliament, where manufacturers, bankers, industrialists, merchants, and traders meet to pool their views and information and to develop a common policy. This policy is brought to the attention of individual governments, the United Nations, and the whole of world opinion. Essentially, it is the goal of the International Chamber of Commerce to be representative of and to encourage better understanding among businessmen and business organizations of the free countries and to implement that program in the improvement of world economic conditions.

The International Chamber of Commerce has a membership composed of businesses and associations in more than 50 countries. Its economic recommendations are helpful to governments either directly or through the United Nations, where the International Chamber of Commerce has been granted a consultative status with the Economic and Social Council.

The basic United States attitude toward foreign income under the present Internal Revenue Code has been that it should be taxed on a parity with domestic income. Therefore, in general, United States corporations, citizens, and alien residents have been taxed on their entire income regardless of its geographical source. The revision of the code as presently drafted will, however, tend in numerous instances to afford some relief from the disadvantages heretofore acting as a hindrance to an increased flow of United States capital abroad.

2. Throughout the world many countries limit their income taxes to income from domestic sources. Italy, France, Switzerland, Spain, and a number of Latin American countries may be put as examples of that category.

Belgium taxes such income at a reduced rate. England only taxes the profits that are remitted to England, and Canada completely exempts from domestic tax certain companies which are organized expressly for the conduct of business abroad.

Additionally, most European countries have entered into tax treaties providing that the income of the business operations of the nationals of the first contracting country earned in the second contracting country shall be subject to income taxes only in that country where it was earned. This attitude toward the taxation of foreign income gains support constantly.

3. Foreign investment is subject to tremendous risks, such as currency depreciation and restrictions, expropriation, discriminatory application of local restrictive laws, and sometimes even revolutions or other violent interruptions of business operations because of political unrest. Superimpose these risks over the usual ones of getting any business properly financed and profitably operating and it is easy to visualize why the American businessman is prone to resist the blandishments of those who urge him to invest his capital abroad.

In addition, in some instances our present techniques of taxing foreign income result in a higher taxation of American business abroad than that levied on non-American business, making successful operation even more difficult. It is hoped that the revisions of American tax legislation now contemplated will help to alleviate these difficulties.

4. The United States council is gratified that the principle underlying one of the recommendations made by the chairman of its committee on taxation before the House Ways and Means Committee on August 5, 1953, has been adopted in the proposed revision of the Internal Revenue Code. This recommendation was that the definition of foreign taxes allowable as a credit under section 131 be broadened to include the "near income taxes" so widely used in many foreign countries.

Under the "principal tax" concept now proposed, however, the committee on taxation believes that in many instances the provisions may operate to make

a smaller credit available to taxpayers than that available under present law. The proposal that a taxpayer be required to choose between the income tax and the principle tax, for this purpose, would cause inequities to those receiving income from countries where taxes in both of these categories are collected on income. It would therefore appear that the intent of law would best be achieved by allowing credit for the aggregate of all taxes intended to be imposed upon the income in the foreign country, i. e., the sum of the income tax, the "in lieu of" tax, and the "principal tax."

5. A second recommendation which the council made in testimony before the House Ways and Means Committee was that the tax incentives granted to Western Hemisphere trade corporations be extended on a global basis. The council welcomes the step in this direction which is set forth in section 923 of the proposed revision of the Internal Revenue Code. It is noted that the intent of this section is to grant tax credit, similar to that applicable to Western Hemisphere trade corporations, where the American taxpayer is engaged in the conduct of a business involving a significant investment abroad.

The need is recognized for wording which will restrict the benefits of this section to the businesses for which they are intended. However, as presently phrased, no mention is made of many foreign investment and business activities such as agriculture, lumbering, wholesale distribution and marketing, warehousing, assembling, refining, marine, and pipeline transportation and construction, and operations incidental thereto. There are generally considerable investments in these categories of business, but the specific designations in the proposed revision might result in excessively narrow requirements on the types of foreign business income which would qualify for the lower tax rate. The language could be interpreted to deprive taxpayers with significant overseas investment and activity from receiving the benefit of the incentive rate, and appropriate clarification is therefore recommended.

6. The council also recommended that the exemption from United States income tax granted to American citizens on income earned abroad (where the citizen is not a bona fide resident of the foreign country) be increased from $20,000 to $35,000. The revision of the Internal Revenue Code now proposed does not change the present ceiling. Many foreign-employed executives and employees are paid salaries in excess of this figure as an inducement to tolerate the often primitive working conditions overseas, and they will be inequitably treated if the $20,000 limit remains. For this reason the council wishes to repeat its previous recommendation that the ceiling be raised.

7. The United States council also proposed that the United States Government recognize the principle that the country where income is earned should have the exclusive right to tax that income. This principle was not given full recognition in H. R. 8300, and the council looks forward to the time when conditions may be favorable for its further consideration

8. The council has taken note of section 904 of the proposed revision of the code which would provide as a limitation on the foreign tax credit only the "per country" limitation and would repeal the "overall" limitation by omission. The repeal of the latter is meant to remove an element which "discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years."

Some taxpayers deriving income from foreign investment will be benefited by this amendment in section 904 which permits the offset of foreign losses against domestic income. However, it may prove to have certain discriminatory effects, in that similar relief is not granted to those American corporations which are operating efficiently in a number of foreign countries where income-tax rates vary widely, both above and below the United States level. Possible benefits from elimination of the per country limitation should therefore also be examined, together with the proposal which has been advanced that taxpayers be granted the election annually as to whether they will apply the overall of the per country limitation in computing their foreign tax credit.

9. Last, it is noted that section 923 requires a United States shareholder to meet one of the following requirements in order to secure benefit of the preferential rate on dividends from a foreign corporation: (1) own together with not more than 3 other domestic corporations more than 50 percent of the voting stock of the foreign corporation, or (2) own at least 10 percent of the voting stock of the foreign corporation and have a business relating to that of the foreign corporation by reason of the rendition of technical, engineering, scientific, or like services.

In order to be consistent with the test prescribed in section 902 for securing a credit for taxes paid by a foreign subsidiary, it is recommended that a minimum percentage of ownership requirement be established without the other restrictions indicated under (2) above.

10. The United States council believes it is essential for the United States to encourage private investment abroad, especially in those countries which need and want foreign capital. Such investment will raise the standard of living everywhere. In that way we will most effectively fight communism and lessen the risk of war and revolution. We will create new and dependable sources of minerals and essential materials.

Finally, the encouragement of private investment abroad will be in direct furtherance of one of the cardinal principles of the President's program for the foreign economic policy of the United States.

THE WARNER & SWASEY CO.,
Cleveland 3, Ohio, April 23, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: Realizing the pressure under which your committee has been working in the consideration of H. R. 8300, I did not request time to testify before the committee inasmuch as I am a private citizen, representing this company with which I have been connected for 35 years. Section 167: Depreciation is not satisfactory in its present form in H. R. 8300 because the taxpayer is definitely tied to the unrealistic useful lives in bulletin F. I should, therefore, appreciate your including the proposal which I make herein in the official record of the committee hearings. The proposal is as follows:

Risk capital is not invested in manufacturing facilities, either a new business, additional capacity, or replacement, unless there is a demonstrated rate of return upon the capital so invested. This is new income, over and above the normal income upon which budget estimates are based and upon which the effect of estimates of depreciation deductions are computed. Since this return on the investment is known as the time the investment is made, the taxpayer making the investment should be able to negotiate with a delegate of the Secretary of the Treasury and agree upon an annual amount of depreciation which will not exceed the expected additional income from the new capital investment.

The national revenues would thus be protected since the agreed upon depreciation would not exceed the income from the new investment and there would be an incentive provided for the new business to go forward and for existing companies to replace obsolete and worn equipment. This is demonstrated simply in the following way:

Proposed investment	$1,000,000	
Demonstrated return on investment 30 percent (new income)		$300,000
Equipment replaced, original cost	$500,000	
Annual depreciation on $1,000,000 on 5-year basis	200,000	
Present depreciation at 5 percent	25,000	
Net increase in depreciation charge		175,000
New income subject to tax		125,000

I would, therefore, propose the following:

Insert at end of section 167 (d):

"In the case of property referred to in subsection (c), such agreement may provide for the allowance as deductions under subsection (a) of amounts aggregating not more than the basis which is properly attributable to such construction, reconstruction, or erection, or to such acquisition, after December 31, 1953, upon such method and over such period of time (whether more or less than the useful life of such property) as the taxpayer and the Secretary or his delegate agree would not in the normal operation of such property result in a reduction of the taxable income of the taxpayer to an amount less than the taxable income which would in such normal operation have resulted had such property not been acquired."

There are many arguments that can be made for this proposal but the most important point is that the additional income out of investment in new facilities can be proved.

I would, therefore, appreciate the consideration of the above proposal by the committee.

Yours very truly,

L. D. McDonald,
Executive Vice President.

STATEMENT OF CLINTON M. HESTER, WASHINGTON COUNSEL, UNITED STATES BREWERS FOUNDATION ON CHAPTER 51 OF H. R. 8300

Mr. Chairman and members of the Senate Finance Committee, my name is Clinton M. Hester. I am an attorney in the Shoreham Building, this city, and appear here today in behalf of the United States Brewers Foundation, 535 Fifth Avenue, New York City, for which association I have been Washington counsel for many years. This association, established in 1862 and in continuous operation since that date, is believed to be the oldest trade association in the United States. Its members manufacture over 85 percent of all the beer produced in the United States.

The United States Brewers Foundation respectfully recommends enactment of chapter 51 of H. R. 8300. This chapter would modernize the laws and regulations governing the operation of breweries and the collection of beer excise taxes. This would be accomplished by repealing obsolete statutes, by permitting the payment of beer excise taxes periodically, and by authorizing the Secretary of the Treasury or his delegate to prescribe new regulations limited to the protection of the revenue.

Chapter 51 would achieve the chief objectives of 4 separate bills introduced during the last session of this Congress by 4 members of the House Ways and Means Committee, Representatives Dingell, Forand, Byrnes, and Eberharter.

The laws and regulations of today trace their origin back to the time of the Civil War. Now, as then, the brewer, from the time he purchases his raw materials until he pays his beer excise taxes and sells his finished product, must work his way through a labyrinth of laws and regulations.

Many of these regulations, which regulate almost every activity of the brewer in the manufacture of his product, have no relation to protection of the revenue. In this respect they violate an important principle of constitutional law, i. e., that the Government, to aid it in the collection of revenue, is authorized to issue only such regulations as are necessary to protect and insure collection of the revenue. Under the guise of the taxing power vested in the Congress by the Constitution, the Congress cannot authorize, nor can the Treasury Department issue, regulations for the collection of revenue when their primary purpose is to regulate the operation of an industry, such as the brewing industry, rather than to protect and insure collection of the revenue.

One example suffices to illustrate the regulatory character of many existing requirements which are totally unnecessary to protect and insure collection of beer excise taxes. Under one specific ancient regulation every brewer is required to maintain elaborate and costly drawings (known as plats and plans) of the complete brewery premises. As a result, some brewers must employ permanently architects or draftsmen to meet this particular requirement, while others must engage the services of firms which specialize in this work.

When a brewer makes any change, even as slight as moving a pipeline, that fact and the new location must be accurately reported to the Alcohol and Tobacco Tax Division of the Internal Revenue Service. Inspectors of this service must then travel to the brewery for the purpose of examining and approving each change and checking the accuracy of its location. We understand that Government inspectors in 1 recent year had to process, through examination and inspection of the premises, 65 different revisions in brewery plats and plans made by only 1 brewery. This is not at all unusual.

In this connection it is interesting to note the observations made by Internal Revenue Commissioner T. Coleman Andrews in his testimony in 1953 before the House Appropriations Subcommittee on Appropriations for the Treasury Department:

"I have always had considerable doubt in my mind as to whether we need all the Government men whom we find around distilleries * * *" (record of hearings, April 2, 1953).

Of course, what Mr. Andrews said of distilleries is even more applicable to breweries.

Mr. Dwight E. Avis, director of the Alcohol and Tobacco Tax Division of the Internal Revenue Service, expressed his views as to the necessity for modernizing these ancient laws and regulations in an address before the State Liquor Commissioners meeting in annual convention in New York City in September 1953, in part as follows:

"The present internal revenue liquor laws were enacted in the horse-and-buggy days and in many of their aspects are archaic and outmoded and no longer entirely adaptable to modern business operations or to realistic regulatory control."

The House Ways and Means Committee in its report on H. R. 8300 succinctly and cogently stated the case for this revision measure (ch. 51) when it observed (pp. 50–51):

"The committee has substantially revised the provisions of present law relating to alcoholic beverages * * * although no changes in tax rates are made. Present law has been rewritten to delete obsolete provisions, remove unnecessary recordkeeping requirements, and permit greater freedom to producers and the Treasury Department to meet changing commercial practices. It is anticipated that the changes made by your committee's bill will substantially reduce the compliance costs of the industries concerned and permit more efficient administration.

"In the case of the excises * * * your committee has provided that the taxes are to be paid by returns rather than by the purchase of stamps. The bill provides the Secretary may institute the return system at any time after January 1, 1955. The period for which the returns are to be filed, the time of filing, and other details are to be prescribed by regulations. Representatives of the Treasury Department have told your committee that while no definite date has been set for instituting the return system, plans have been made to require a weekly return when the plan is first put into effect. Subsequent extension of time for filing returns will be dependent on the fiscal situation and on the experience with the weekly return.

"Under present law taxes on these products are paid for by the purchase of stamps which must be affixed to packages or containers prior to or at the time of removal of the products from the factory or other bonded premises. Because of this procedure, producers must finance tax payments between the time the stamps are purchased and the time they receive payment for the taxed products from their vendees. Such financing increases the working-capital requirements of producers by many millions of dollars, and the producers have requested that they be permitted to pay the taxes on a delayed-return basis as is provided in the case of most other excises. Your committee's action recognizes the burden of the present system on producers and provides a method whereby a changeover can be made to a delayed-return system."

The change to a reporting system which permits the brewer to pay beer excise taxes in much the same manner as he and all other businessmen are permitted to pay their corporate and individual income taxes is something that the brewing industry has looked forward to for years. The same reporting system of collecting beer taxes has long been in effect in numerous States and is the method Congress has approved for the collection of beer excise taxes in the District of Columbia.

Moreover, neither the District of Columbia, nor any State which has adopted this practical and modern method for paying beer excise taxes, regulates brewers in the manufacture of their product, as does the Federal Government.

The Federal Government today collects some $60 billion in corporate and individual income taxes by allowing the taxpayer to examine his books, determine what he owes, report the amount to the Government, and transmit his check in payment of the taxes. On the other hand, the Federal Government in collecting less than $800 million annually in beer excise taxes requires brewers to comply with a maze of ancient laws and regulations in the manufacture of their product, and in the payment of their beer excise taxes.

As pointed out previously, many of the ancient regulations being repealed or modernized by chapter 51 have no relation to the protection and collection of the revenue.

Where the Congress authorizes the issuance of regulations to carry out the purposes of a statute, particularly whereas under chapter 51 the Secretary of the Treasury or his delegate is given authority to prescribe regulations to aid in the collection of beer excise taxes, there is in the authority a constitutional restriction limiting the regulations to those necessary to aid in the collection of the

taxes. However, this constitutional limitation on the authority to issue the regulations is not generally understood, and for this reason the executive branch of the Government has in the past issued some regulations which were not necessary to carry out the purposes of the statute.

Assurances that no regulations, not authorized by statute, will be issued while he is in office were given in 1953 to the House Appropriations Subcommittee on Appropriations for the Treasury Department by Commissioner T. Coleman Andrews, of the Internal Revenue Service, in the following testimony:

"There are several policy matters that concern us and the first is the matter of regulations. There have been a great many complaints made to us in the Treasury Department and the Bureau—and I know a great many to you gentlemen and I suppose also to the Joint Committee on Internal Revenue Taxation—that the Bureau has oftentimes sought to accomplish by regulation what it was not able to accomplish by legislation and I want you gentlemen to know that I regard that as an improper policy and it will not be followed as long as I am Commissioner of Internal Revenue.

"I say that without necessarily meaning to be critical of anybody, but I feel that if Congress does not give the kind of laws the administration wants, the administration ought not to try to get that law by warping its regulations so as to drag it in.

"We want to ferret out those regulations that are not consonant with the law and, as we find them, we are going to change the regulations. And when I say that, of course, bear in mind that I speak with the authority of the Secretary. These matters have been discussed with him. That means also that, as we go along, we will try studiously to avoid a construction of the law and the regulations that will incorporate legislation that was not intended." (Record of hearings, p. 612, March 27, 1953, 83d Cong., 1st sess.)

Mr. Elbert P. Tuttle, General Counsel for the Department of the Treasury, in an address on April 4, 1953, before the Florida Bar Association at Hollywood, Fla., said much the same as Commissioner Andrews. In the course of his remarks Mr. Tuttle stated:

"What we cannot get Congress to pass by law we will not get by regulation * * *

* * * * * * *

"Whatever solution is worked out will, it is hoped, result in a businesslike administration based upon objective interpretations of the acts of Congress and on regulations honestly designed to carry out the intent of Congress, rather than regulations and interpretations reflecting a philosophy or policy not laid down by law.

* * * * * * *

"To the extent to which we fail to meet this exacting obligation, we would appreciate your calling us to task. We assure you that you will receive a respectfull and interested audience."

Years ago it may have been believed that the collection of beer excise taxes could be achieved only by regulating almost every activity of the brewer in the manufacture of this product. This will no longer be true if Congress enacts chapter 51 of H. R. 8300 and permits brewers to pay their beer excise taxes in the same manner as the Federal Government permits them and all other businessmen to pay their corporate and individual income taxes.

The public assurance of Commissioner Andrews, Director Avis, and General Counsel Tuttle referred to earlier are all the members of the United States Brewers Foundation could desire. However, since public officials change through the years we respectfully request that the Senate Finance Committee make certain that chapter 51, in the form reported by the committee to the Senate, will expressly state in clear and unmistakable language that all future regulations issued pursuant thereto shall be limited to those necessary to protect and insure collection of beer excise taxes. Some provisions of chapter 51 authorize the issuance of regulations and provide that they shall be limited to those regulations necessary to protect and insure collection of the revenue. Other provisions of chapter 51 authorize the issuance of regulations but do not expressly so limit that authority. May we therefore respectfully suggest that a final section be added at the end of chapter 51 reading somewhat as follows:

"The Secretary of the Treasury or his delegate is authorized to prescribe regulations necessary to carry out the purposes of this chapter: *Provided, however*, That such regulations shall be limited to those necessary to protect and insure collection of the revenue."

Or instead of the proposal just mentioned, may we respectfully propose that wherever in chapter 51 the Secretary of the Treasury or his delegate is author-

ized to issue regulations without any express limitation on such authority, there be incorporated into the authorization an express limitation in the form of a standard to guide the Secretary or his delegate in the exercise of such authority. The standard to be that such regulations are to be limited to those necessary "to protect and insure collection of the revenue."

May we further respectfully request that the committee make it clear in its report, that the committee expects the Secretary of the Treasury or his delegate to be guided by the standard "to protect and insure collection of the revenue" in issuing regulations to carry out the purposes of chapter 51.

The enactment of chapter 51 will bring to fruition a goal long sought by the brewing industry; namely, the modernization and simplification of laws and regulations governing the operation of breweries and the collection of beer excise taxes, born, to use the words of Mr. Avis, "in the horse and buggy days."

As recently as March 25, 1954, in testimony before the Senate Appropriations Subcommittee on Appropriations for the Treasury Department, Internal Revenue Commissioner T. Coleman Andrews recognized the need for "eliminating archaic practices which have been imbedded" in "our alcohol * * * tax requirements, procedures, and practices" (hearings, p. 360).

Earlier, on February 1, 1954, Commissioner Andrews, in his testimony before the House Appropriations Subcommittee on Appropriations for the Treasury Department, likewise recognized the need for modernizing and simplifying present governmental controls established under existing law. He also indicated the need for new legislation (ch. 51) to enable the Internal Revenue Service to further accomplish this objective. The Commissioner pointed out, in addition, that all of these changes will result in greater efficiency and economy to the Government and to industry. Commissioner Andrews' testimony was as follows (hearings, p. 563):

"In September of last year, plans were laid to make a comprehensive study of the legislative and regulatory control of the liquor industry. We established an Alcohol Tax Survey Committee on September 8, 1953.

"The Committee has been instructed to develop recommendations for a simplified system of revenue protection and regulatory controls, including the necessary legislative changes to achieve this objective. The work is to proceed in two phases. The first phase will embrace such changes as can be made within existing law to streamline Government supervision of the industry. The second phase will deal with the more basic features of legislation and regulations with a view to modernizing the collection of liquor taxes and permitting changes in supervision that cannot be achieved under the first phase. The controlling purpose in both phases of the assignment is to work toward supervisory methods that will be more economical for the Government and permit industry to operate as efficiently as possible within the requirements of revenue protection and control.

"In carrying out its work, the Committee is maintaining close liaison with interested industry groups, other Federal agencies involved, and State tax-enforcement officials. This is intended to provide coordination of representative interests as the work proceeds.

"The Committee has been engaged thus far mostly in preliminary work. During this time it has also participated in the work of reorganizing the alcohol tax phases of the Internal Revenue Code and incorporating certain acceptable changes immediately desired by the industry. It will shortly undertake initial steps toward modifying present supervisory practices, which appear feasible and desirable under present law. As a result of these steps it is anticipated that some economy in the operation of the Alcohol and Tobacco Tax Division will be realized during the fiscal year 1955. However, the more basic phase of the work will not be completed until some time during the fiscal year 1955 when the ultimate potential savings should be more fully apparent. The full realization of savings will depend upon legislative action providing basic changes in the present law."

We respectfully urge too that all of the provisions of chapter 51 be made effective upon the date of its enactment with one exception. We fully appreciate the reasons why the Treasury Department desires to have the Congress postpone until January 1, 1955, the institution of the new tax-payment system for the collection of beer excise taxes.

Accordingly, with the suggested amendments included, we earnestly request the committee to recommend to the Senate approval of chapter 51.

Thank you, Mr. Chairman, and members of the Senate Finance Committee, for your indulgence.

WENCHEL, SCHULMAN & MANNING,
Washington, D. C., April 23, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington, D. C.
(Attention: Miss Dorothy A. McRae, administrative assistant.)

DEAR SENATOR MILLIKIN: We wish to bring to your attention as chairman of the Senate Finance Committee, in order that it may not be overlooked, a revision which should in all fairness to the taxpayers concerned be made in H. R. 8300 to correct a change to their detriment which must have crept into the drafting of the bill by oversight.

The taxpayers we have in mind are the American beneficiaries of a nonresident employees' trust established abroad in sterling funds. Contributions by the domestic employer to this trust on their behalf ceased a number of years ago when a domestic trust was established for them, but because of monetary controls their accumulated credits to that time in the sterling trust had to remain in said trust. As to their interests the trust is now merely a liquidating trust. To the extent of their interests this trust was qualified by the Internal Revenue Service as an exempt employees' trust under section 165 (a) of the Internal Revenue Code of 1939. They are presently entitled, therefore, under section 165 (b) of the 1939 code, to capital-gains treatment where total distributions payable to them under the trust are paid to any of them in 1 taxable year on account of separation from service (including retirement, etc.).

H. R. 8300, however, provides in section 501 (e) that thereunder only employees' trusts created or organized in the United States are eligible to qualify as exempt trusts, and the capital-gains treatment for total distributions to beneficiaries is restricted in section 402 (a) (2) to the distributions only from trusts that can qualify under section 501 (e). Thus, total distributions from a previously qualified nonresident trust are excluded from capital-gains treatment. The above-mentioned American employees who have unliquidated credits in such a nonresident trust would thus lose the benefit of participation therein. This surely is merely a drafting oversight, as there is no good reason why they should now be cut off midstream from that benefit, even if hereafter no other nonresident trusts are to be qualified as exempt employees' trusts.

The continuation for 1954 and later years of the exempt status of trusts exempt under section 165 (a) of the Internal Revenue Code of 1939 is provided for in section 403 (c) (1) (A) and (B) of H. R. 8300. This provision, however, appears in section 403 which is concerned only with the definition of deductible contributions to such a trust by the employer. The language of section 403 (c) (1) (A) and (B) is in terms broad enough to embrace the continuation of the exempt status of any employees' trust qualified under section 165 (a) for both the contributions thereto by the employer and the distributions therefrom to the employees. But as it appears in section 403, devoted only to contributions by the employer, the administrative interpretation would undoubtedly be that it cannot be extended to cover distributions to employees. This provision clearly appears to be out of place, and if it were transferred therefrom and inserted at the end and as a part of section 501 (e), which has to do with the qualification of exempt employees' trusts for both purposes, the inequity unwittingly done to the American employees would automatically be corrected. This would have the effect of bringing their distributions within the present language of section 402 (a) (2).

We have brought the foregoing matter to the attention of Mr. Colin Stam, of the Joint Committee on Internal Revenue Taxation, and Mr. Edward C. Rustigan, assistant to Mr. Kenneth W. Gemmill, of the legal advisory staff of the Treasury, who have received it with sympathetic attention and intend, we feel, to bring it before the Finance Committee with an agreed proposed correction. However, as they have many things to consider in connection with H. R. 8300, we bring the matter to your attention by this letter in order to insure that it is brought to the attention of the Finance Committee.

Copies of our letters to Mr. Stam of April 9, 1954, and April 12, 1954, in reference to this matter are attached for your files. Identical letters were filed with Mr. Rustigan under the same dates.

You will see from the last paragraph of our letter to Mr. Stam of April 12 that there are approximately 4,070 employees whose interests are involved in the case with which we are concerned.

Sincerely yours,

ELLIS W. MANNING.

EDWARDS & ANGELL,
Providence 3, R. I., April 24, 1954.

Re H. R. 8300
Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance, Senate of the United States,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: The situation created by H. R. 8300, the proposed Internal Revenue Code of 1954, is a most serious one, and I am sure you will pardon me if I speak very frankly about it. If our position were reversed, I would wish you to do the same.

The opinion which I express is not merely my own, but is shared by a number of experienced practitioners, both lawyers and accountants, whose views are entitled to great weight.

The bill undertakes to rewrite the Internal Revenue Code. This of itself is a stupendous task, and it is not within the realm of reason that it could have been wisely or satisfactorily accomplished in the time allowed for the task. While the present code is complex and in many respects difficult to understand, the proposed revision is, in our judgment, infinitely worse. We do not see how it can possibly be put in satisfactory form, except after a much longer period of study and discussion than has been permitted and a more thorough consideration of the bill's numerous defects.

The job is one for men of long practical experience and mature judgment, and not for the theorist. The bill has all the earmarks of having been drafted largely by the latter. Federal income-tax legislation has been in effect in this country for over 40 years, and estate-tax legislation for almost as long. There are many capable men with sound judgment who have spent the greater part of their professional careers in the study and practical application of these laws. A measure of this sort should not be enacted without allowing ample time for consultation with men of this character and the giving of due weight to their opinions. This, I fear, has not been done.

If the present bill, even with such changes as are likely to be made within the time allowed for revision, should be enacted into law, it would impose upon the taxpayers and the Government an enormous task of interpretation which would be most costly to everyone concerned.

The provisions of subchapter C, dealing with corporate distributions and adjustments, are particularly objectionable. They constitute, as a whole, one of the most amazing and disappointing pieces of legislation I have ever encountered. Whatever may be done with the rest of the bill, I hope most earnestly that subchapter C will be withdrawn and that any action with respect to it will be postponed until the subject can be far more thoroughly studied.

I am enclosing a memorandum by my partner, Mr. Jacobson, and myself, discussing several provisions of the bill to which we should like to call particular attention.

With kindest regards, I am
Very sincerely yours,

R. B. DRESSER, *Counselor at Law.*

MEMORANDUM REGARDING H. R. 8300

I. SECTION 309

Granted that the basic purpose of this section may be sound, namely, to prevent so-called bailouts, the provision is so drastic and so unpredictable in its results, because of the technicalities surrounding it, that it may well reach situations for which it is not intended and fail to cover some of the very cases which it is intended to reach.

Much testimony must have been presented on this, but at the risk of repetition, let us call attention to the fact that this may penalize individuals who reap no benefit, or practically no benefit, from the redemptions which it seeks to prevent by its penalties. Thus, unless the owners of the redeemed nonparticipating stock and of the participating stock are substantially the same, the cost of this extreme penalty will be borne not by the holders of the nonparticipating stock whose stock is redeemed, but by the remaining participating stockholders, the value of whose interest in the corporation is reduced by the imposition of this drastic penalty.

It seems to us that this has been approached from decidedly the wrong angle. If bailouts are to be prevented, the penalties to prevent them should be directed at the parties who are going to receive the benefit and not at other parties.

But in any event, if the provision is to remain, it should not apply to issues prior to the passage of the act. If preferred stock was issued some years ago and the purpose was bailout, it would have been redeemed before this. If the purpose was not bailout and the stock is still outstanding, this drastic provision in all fairness should not apply.

II. SECTION 535 (B) (3)

We believe that this provision accomplishes a result which cannot have been intended. It provides that for the purposes of determining "accumulated taxable income" (formerly known as sec. 102 income) the special deductions for corporations provided in part VIII (of subch. B), the principal one being the former "Dividends received credit," shall not be allowed. Explanation of what we believe was an unintended effect of this provision must be rather technical and can best be made by giving an example, as follows:

Under section 112 (b) (6) of the 1939 code, a wholly owned subsidiary could be liquidated into its parent corporation without any tax impact. The parent corporation simply took over and stood in the place of the subsidiary with respect to its assets, income, etc. Section 332 (b) (1) of the proposed code provides that certain amounts distributed by the subsidiary under such circumstances shall be treated as dividends, but that the parent corporation's deduction for dividends received (formerly "dividends received credit"), shall in such case be 100 percent instead of the customary 85 percent. That is alright with respect to the normal tax and surtax upon the receiving corporation, but as we read the statute it appears that when you come to section 531, which takes the place of the old section 102, the entire amount which, under section 332 (b) (1), is treated as a dividend paid by the subsidiary corporation in the year of its liquidation, becomes a part of the income of the parent corporation for that year for accumulated earnings tax purposes. In other words, it results, practically, in throwing the accumulated earnings of the subsidiary over what may be a very long period of years into the accumulated taxable income of the parent corporation for the year of liquidation. We do not believe that any such result could have been intended.

It may be that this could be cured by a slight amendment of section 535 (b) (3), excepting from the provisions of that paragraph amounts paid by the subsidiary to its parent as part of a liquidating distribution and treated as dividends under section 332 (b) (1).

III. SECTION 359

Throughout subchapter C there are numerous situations where "publicly held" corporations, as defined in section 359 (a), receive different treatment from corporations which do not qualify as "publicly held." It is our opinion that these distinctions should be eliminated. They discriminate against both the closely held corporation of substantial size and the small business corporation.

Because of such differing rules in the cases of "publicly held" and "nonpublicly held" corporations, closely owned businesses, whatever their size, and all small businesses are handicapped in those corporate and financial adjustments which from time to time become absolutely necessary for the most effective employment of their capital. A small business, of course, cannot qualify as a "publicly owned" corporation. Such businesses simply are not large enough. As subchapter C now stands, small-business organizations are more restricted in what they can do than are the large corporations whose stock is widely distributed.

We can see no economic or other justification for this treatment of small or closely owned corporations, which play such an important part in our economy. The handicaps imposed upon them by this legislation would be such, we fear, as to cause many of them to go out of business. If the Government feels that business should be conducted by large corporations rather than small ones, this is just the sort of legislation to pass.

This discrimination, we submit, is arbitrary and unjust, and not in the public interest. We urge that the distinction be eliminated.

Respectfully submitted.

ROBERT B. DRESSER.
ROBERT E. JACOBSON.

INCOME TAX SERVICE,
Chicago, Ill., March 25, 1954.

DEAR SENATOR: Please defeat the administration proposal. There is no need to extend the date for individuals to file income-tax returns from March 15 as at present, to April 15 as proposed.

The administration alleges that more complicated cases require additional time so as to minimize pressure on accountants and attorneys. This may be true for more complicated cases. It certainly is not true for the substantial majority of income-tax payers.

Of 245 customers whom I serviced this year, not 2 percent were "more complicated." Yet, even these were handled on time because the customers had not waited until the last days but had come with their problems in February. That allowed time enough to make inquiries and secure information needed to process the completion of their reports.

The other 98 percent of my customers are primarily wage-earners—with a sprinkling of self-employed or small-business men and landlords living in their own apartment buildings. They do not have more complicated income-tax problems. They need no extension of time. In fact, most of them procrastinate—unreasonably.

Approximately half of my customers are repeaters, customers whose work I handled the prior year in this, a transition neighborhood where I lose old, and gain new, customers. The excessive procrastination of these, old and new customers is indicated by my experience. This year, I sent notices to old customers in January; a small number responded and I serviced them in January and prior to mid-February. At that time, as in prior years I opened a temporary office in a nearby store and sent another notice to old customers about February 18. In addition, I placed a large (3-foot by 5-foot) income-tax service sign in the window of the store. Pedestrians and bus riders stopping at this corner store, could not miss seeing these signs.

It was not until March 8, only a week before the deadline, that I was handling as many as 10 customers a day. On March 12, there were 15; and on March 13 and 15, the exhausting numbers of 28 and 38, respectively. These customers could have come weeks earlier. Instead, they procrastinated—as in prior years—until the last 3 days primarily.

There is no justification to extend time for them. Extension will mean that they will procrastinate—more. For such customers, the present practice of the collector of internal revenue providing extensions of time, when requested, will suffice.

The only possible justification to extend time is to relieve an alleged pressure on accountants and attorneys. However, to determine what their experience is, I phoned a half dozen the largest accounting firms in the city. Several desire the extension and claim that it will reduce the present pressure on them from January 1 to March 15; but some of these, when questioned, admit that this pressure occurs prior to January 15, and again in March, with an intervening lull. Some admit that if they circularized their customers earlier in the season, the pressure of the last weeks could be reduced and the work spread throughout the season.

Every firm hesitated, didn't want to estimate the percentage of "more complicated" cases that require extensions of time. The number was small. When I suggested "10 percent?" the answer was "No." They wouldn't even volunteer "5 percent." The conclusion is that it is possibly several, certainly not 5 percent.

This—and no doubt it is typical throughout the Nation—disclaims any need for a general extension until April 15. Its motivation appears to be for the administration to claim political advantage—with no benefit, but harm, to most taxpayers.

Sincerely yours,

ALBERT BOFMAN.

NATIONAL COMMERCIAL FINANCE CONFERENCE, INC.,
New York, N. Y., April 5, 1954.

Re sections 6323 and 163 of the Internal Revenue Code of 1954.

To the honorable, the Members of the Finance Committee of the United States Senate:

This letter is being respectfully addressed to you with respect to sections 6323 and 163 of the Internal Revenue Code of 1954, on behalf of the National Commercial Finance Conference, Inc., to which I am general counsel.

The 78 members of the conference are engaged in commercial financing, principally in satisfaction of the needs of small and medium-sized business, on a national, regional, and local basis. Their customers are predominantly manufacturers and wholesalers, of growing character. Credit is extended on a secured basis, chiefly upon the security of factors' liens, trust receipts, government contracts, private accounts receivable, and inventory and machinery loans. In 1953, the estimated aggregate national volume of such financing was upward of $7 billion. In addition, some of our members finance the consumer purchase of automobiles, household appliances, etc., either directly in the extension of credit-accommodation to dealers upon the security of consumer chattel paper, or by rediscounting it. They also finance the charge accounts of department stores, etc., which is known as "budget financing." The national volume of all such consumer financing is, of course, even larger.

The interests of our members—and, even more importantly, of their customers—are vitally affected by sections 6323 and 163 of the proposed Internal Revenue Code. While we do not object to the underlying policy of these sections, they would, in their present language, be seriously, and unnecessarily, injurious to the extension of credit to small business and consumers.

We therefore have the following suggestions for their amendment, which we feel that we should call to your attention, for such action as, in the national interest, you may deem it appropriate to take thereon.

I. SECTION 6323

(*a*) Section 6323 relates to tax liens.

The most serious problem raised by its language relates to the definition of the class of persons who are protected against the Federal tax lien unless notice thereof has been recorded. As presently written, the section gives such protection only to those who may qualify as mortgagees, pledgees, purchasers and judgment creditors. We believe that protection is necessary for all persons taking a security interest in property, and that those who purchase or loan on assignments of accounts receivable, security interests by way of trust receipts, factors' lien or any of the other devices for obtaining security commonly used in the commercial world, should have the same status as mortgagees and pledgees. These problems are very real, for we understand the Commissioner, in the past, has raised the question as to whether some of the above-mentioned types of transactions are presently protected under the corresponding language of IRC section 3672, the existing counterpart of section 6323.

We therefore respectfully submit that the language of section 6323 should be revised in order to make it clear that the persons protected by it are not confined to those who may fit the narrow technical definition of "mortgagee" or "pledgee."

This problem is now of additional importance in connection with the recent promulgation, by the American Law Institute and the National Conference of the Commissioners on Uniform State Laws, of the proposed Uniform Commercial Code. It has already been adopted in Pennsylvania, and it is being considered for adoption, either by the legislatures themselves or special commissions, in a number of important commercial States, including New York, Massachusetts, California, and Indiana.

Under the Uniform Commercial Code, broadly speaking, all previously existing specific security devices are merged into a single lien concept, known as a security interest, and persons holding a security interest are known as secured parties. Thus, in Pennsylvania after July 1, 1954 (the effective date of the Uniform Commercial Code), there will be (under a very possible construction of the code) no mortgagees or pledgees at all. There will be only secured parties.

We submit that all of the various security devices encompassed in article 9 of the Uniform Commercial Code clearly merit the protection afforded under IRC 3672 and the proposed section 6323. If such protection is not extended, it can have very far-reaching results. Valid types of security interests now protected against Federal tax liens may lose that protection: other types equally deserving will not have protection: and much confusion and litigation is likely to result.

Accordingly, we earnestly recommend that section 6323 (a) of H. R. 8300 be amended by inserting, after the words "judgment creditor," the following: "or holder of a perfected lien or security interest * * *"

(*b*) In the framing of section 6323, another—and perhaps even more serious—problem has arisen in connection with subdivision (c) of that section.

Under the corresponding section of the present law (sec. 3672 (a)), the validity of tax liens as against mortgagees, pledgees, purchasers or judgment creditors, depends upon their filing in designated public offices. This is a simple, objective test, turning upon a fact capable of certain and instant ascertainment. Compliance with it places no undue burden upon the Internal Revenue Service, and is not injurious to the revenues.

Probably in order to obviate the result reached in such an unusually extreme case as *United States* v. *Beaver Run Coal Co.* (3 C. A., 1938, 99 F. 2d 610) the House inserted a provision (sec. 6323 (c) (1)) which provides that, even though the Government fails to file a notice of lien, it shall be valid "as against any mortgagee, pledgee, purchaser, or judgment creditor, if (1) in the case of a mortgage, pledge or purchase, such mortgagee, pledgee or purchaser, had notice or knowledge of the existence of such lien at the time the mortgage, pledge or purchase was made * * *."

The cure is worse than the disease, because it would superimpose, upon the present simple, objective test of filing, an additional subjective one, dependent largely upon circumstantial evidence, the final determination of which would have to rest upon a jury verdict, possibly years after the event. Therefore, in place of the present precision, we shall have uncertainty and doubt. The resultant cramping of the extension of secured credit, to the injury of small borrowers and lenders alike, is obvious, and far beyond any minuscule protection of the revenues that the addition of this onerous provision would entail.

Then, too, its unfairness is manifest. Take for illustration, a large metropolitan bank, with hundreds of employees. The Government has a tax lien against one of its depositors, but has neglected to file it. In casual conversation when making a deposit, the depositor tells a junior clerk in the teller's cage that the Government has a tax lien against him, not even specifying its nature or amount. Days or weeks later, the depositor effects a loan through the bank's loan officer, but tells him nothing about the unfiled tax lien. Should the teller's knowledge be attributed to the loan officer? And yet, this result would be not merely possible but probable under this new and burdensome provision.

We therefore respectfully suggest that subdivision (1) be eliminated from section 6323 (c); that its introductory sentence be appropriately conformed; and that its final wording read as follows:

"LIEN VALID WITHOUT NOTICE IN CERTAIN CASES.—The lien imposed by section 6321 shall be valid without filing of notice thereof as against any judgment creditor, if—

"(1) the judgment creditor has not obtained a valid judgment in a court of record or of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money, or

"(2) the judgment creditor has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money but has not perfected a lien under such judgment with respect to the property involved."

II. SECTION 163

In the field of consumer financing, section 163 raises an equally serious, though unrelated, problem.

Current Law Respecting Time Sales

Since the case of *Hogg* v. *Ruffner* (66 U. S. 115) decided in 1861, it has been consistently held that the difference between a cash price and a time price on the time sale of any commodity is not interest, and therefore is not subject to the limitation of our conventional interest statutes. See annotation in 143 American Law Reports 238.

In our experience, it is imperative that the validity of this so-called time price doctrine be maintained, since it is universally recognized that it is this principle which furnishes the legal basis for the time-selling industry and that it is an absolute necessity to the mass distribution and marketing of motor vehicles, domestic appliances and other commodities usually sold on time. From the social and economic standpoints, the preservation of the time sales doctrine is vital to keeping mass production and the availability of consumer credit organically and functionally reciprocal. As the past 50 years of our industrial development demonstrate, without mass marketing, mass production would be impossible, and the adverse effect upon employment, the flow of consumer goods, and other economic consequences, cannot be overemphasized.

The language of section 163 confuses a finance charge with the concept of interest, which conceivably could lead to a judicial attitude, as has already been indicated in some spots, that a finance charge constitutes interest.

Present tax treatment of finance charges

Interest payments made by borrowers are deductible under present law, but, as a matter of administrative practice, a similar deduction for finance charges has been denied. This denial of a deduction has been consistent with the time price doctrine in that finance charges are not interest.

Changes in substance proposed by section 163

The proposed section 163 of H. R 8300 continues to allow a deduction for interest paid, and, in addition, authorizes a deduction for finance charges paid, not to exceed 6 percent of the average unpaid balance under the contract during the taxable year.

No one can quarrel with the liberalizing feature of section 163 which accords a deduction to time buyers. It could, indeed, be argued that the time buyer ought to be given a deduction for the full amount of the finance charge, without limitation to 6 percent, but, passing that point, the language of section 163 is deficient, and might lead to serious difficulties.

We therefore suggest that it be amended along the following lines:

Suggested amendment to section 163

(New matter italicized; matter to be deleted enclosed in brackets.)

"(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

"(b) INSTALLMENT PURCHASES WHERE NO SEPARATE INTEREST CHARGE IS [NOT SEPARATELY STATED] *indicated*.—

"(1) GENERAL RULE.—If personal property is purchased under a contract—

"(A) which provides that payment of part or all of the purchase price is to be made in installments, and

"(B) in which carrying charges are [separately stated] *included* but [the] *no* interest charge [cannot be ascertained] *is separately indicated*.

then the payments made during the taxable year under the contract shall be treated [as including] *for the purposes of this section as if it included* interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For the purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balances outstanding on the first day of each month beginning during the taxable year, divided by 12.

"(2) LIMITATION.—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

"(c) CROSS REFERENCES.—

"(1) For disallowance of deduction for interest relating to tax-exempt income, see section 265 (2).

"(2) For disallowance of deduction for carrying charges chargeable to capital account, see section 266."

Respectfully submitted.

MILTON P. KUPFER,
General Counsel.

THE SAVINGS BANKS RETIREMENT SYSTEM,
New York, N. Y., April 26, 1954.

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

DEAR SIR: The savings banks retirement system, a pension trust organized by the mutual savings banks of New York State to provide retirement benefits for the employees of mutual savings banks, and having 4,720 participating employees and 253 retired participants, wishes to call the attention of the Senate Finance Committee to an ambiguity in section 505 of H. R. 8300, the revenue revision bill of 1954, as passed by the House of Representatives and presently under consideration by the Senate Finance Committee.

According to the announcements issued by the Ways and Means Committee and the report issued by it in connection with the bill, section 505 is intended to require diversification of investments by pension trusts which are to be treated as exempt from Federal taxation under the proposed subchapter F. Accordingly, it requires that all of the assets of the trust invested after the effective date of the section be represented either by five specified classes of investment in which unlimited investment is permitted, in—

"Real estate, limited in respect of any one investment to an amount not greater in value than 5 percent of the value ot the total assets of the trust"; or, "other securities, limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and 10 percent of the total combined voting power of all classes of stock of such issuer."

It is not clear whether mortgages of noncorporate mortgagors qualify as securities or real estate within the meaning of section 505, and if they do not so qualify, they would be prohibited under the language of the section. Mortgages, particularly on small family residences, have been recognized for many years as an excellent medium for fiduciary investment. We need not point out, also, that the objects of the national housing policy are furthered if the assets of pension trusts are available for home mortgage lending. We cannot believe that there was any intention on the part of the Ways and Means Committee to prohibit such investment to pension trusts, and the committee report indicates that such was not the intention.

Securities is an ambiguous word, however, and is capable of restrictive interpretation in this respect. We urgently request, therefore, that the Senate amend this bill by substituting for the phrase: "other securities, limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and 10 percent of the total combined voting power of all classes of stock of such issuer" language along the following lines:

"Other investments, limited in respect of any one obligor or issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and, in the case of stock, not greater than 10 percent of the total combined voting power of all classes of stock of such issuer."

The savings banks retirement system has no objection to the proposed requirement that investments of pension trusts be diversified in the manner proposed by the bill. However, since some 61.6 percent of its assets, a total of some $17 million, was invested on March 31 in 2,361 mortgages, practically all of which were on small family dwellings, and since it maintains a staff highly experienced in the making of such investments, it views with concern any possibility that Congress might inadvertently prohibit, or even raise doubt as to the legality of mortgages as an investment for pension trusts. We therefore trust that the bill will be amended to remove any such doubt.

Very truly yours,

ROBERT MATHERSON, Jr., *President*.

STATEMENT OF J. FRANCIS IRETON, MUECKE, MULES & IRETON, BALTIMORE 2, MD., SUGGESTING AN AMENDMENT TO SECTION 163 (B) OF H. R. 8300

INTRODUCTION

Section 163 (b) authorizes a limited deduction for carrying charges paid under an installment-sale contract as if such carrying charges were conventional interest. Decisional law is overwhelmingly settled in this country to the effect that carrying charges are not and do not contain interest. The language of the section should, therefore, be changed to make it clear that carrying charges, even though deductible, are not interest and thus avoid the disastrous economic and social consequences that would flow from a confusion of the legal concept of a carrying charge as interest.

PRESENT TAX TREATMENT OF CARRYING CHARGES

Interest payments made by borrowers are deductible under present law, but as a matter of administrative practice a similar deduction for carrying charges has been denied. This denial is consistent with general law in that carrying charges are not, and do not contain, interest. See *Henrietta Mills, Inc. v. Commissioner of Internal Revenue* (52 Fed. (2) 931).

SUBSTANTIVE CHANGES EFFECTED BY SECTION 163 (B)

The proposed section 163 (b) of H. R. 8300 authorizes a deduction for carrying charges paid not to exceed 6 percent of the average unpaid balance under the contract during the taxable year. No one can quarrel with this liberalizing feature but the language of the section implies that a carrying charge is interest and for the reasons hereinafter stated this language should be changed.

CURRENT LAW RESPECTING TIME SALES

Even before but certainly since the case of *Hogg* v. *Ruffner* (66 U. S. 115), decided in 1861, it has been almost universally held in this country that the difference between a cash price and a time price on the time sale of any commodity, no matter how designated, is not interest, and, therefore, is not subject to the limitation of our conventional interest statutes.

The decided cases point out that the owner of property can sell the same, in the absence of State regulation under the police power, at any price he wishes or that the market may bring. He can sell for cash at one price or on time for another price. The difference, if any, is still part of a price, and is not interest for a loan since a sale and not a loan is involved For illustration reference may be had to the many cases annotated in 143 American Law Review 238.

This is the so-called time-price doctrine.

SUGGESTED AMENDMENT TO SECTION 163 (B)

The language changes in the section indicated below do not in any way alter its policy or intended substance but are solely for the purpose of clarification and to make certain that the existing general legal rule known as the time-price doctrine is not confused with the concept of interest. The matter to be deleted from present section 163 (b) is enclosed in double parentheses, and the new matter to be inserted is underscored.

"(b) INSTALLMENT PURCHASES WHERE *NO* INTEREST CHARGE IS [NOT SEPARATELY STATED] *INDICATED*.—

"(1) GENERAL RULE.—If personal property is purchased under a contract—

"(A) which provides that payment of part or all of the purchase price is to be made in installments, and

"(B) in which carrying charges *howsoever described or designated* are [separately stated] *included* but [the] *no* interest charge [cannot be ascertained] *is indicated*,

then the payments made during the taxable year under the contract shall be treated [as including] *for the purposes of this section as if they included* interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balances outstanding on the first day of each month beginning during the taxable year, divided by 12."

REASONS FOR THE SUGGESTED AMENDMENT

Obviously any inference in section 163 (b) that a carrying charge is interest could lead to a judicial determination that carrying charges are interest. This would mean that carrying charges would be subject to conventional interest rates prescribed by State statutes. The time-selling industry, and this means and includes manufacturers and retailers of such goods customarily so sold as well as banks and other financing institutions who make such sales possible, could not possibly continue to do business and survive under conventional interest rates. The cost of handling periodic payments over a period of time with the clerical bookkeeping expense entailed would be prohibitive at such a charge. The section should be changed to negate the idea that carrying charges are or include interest.

In addition, in some States where time sales are regulated, the varying statutes differently designate carrying charges as "finance charges" or "time price differential." It would be well to indicate in section 163 (b) that the words "carrying charges" mean and include these various other designations.

The time price doctrine, solidly established by 19th century precedents, was adapted to the rapidly growing automobile industry in the early years of the 20th century, and in later years to other commodities, to create a mass consumers market. This, in turn, made possible the development of our boasted techniques of mass production resulting in accelerated technological achievement, in in-

creased employment, in comparatively lower prices, and in a standard of living not equaled elsewhere in the world. To labor, these points is superfluous.

The annual volume of wholesale sales of commodities customarily sold at retail on time, and of retail time sales, and of the volume of financing done in connection therewith, are not readily available. According to Federal Reserve bulletins, automobile and other consumer goods retail time paper outstanding as of December 31, 1953, aggregated approximately $16 billion. Since these figures are outstandings as of December 31, 1953, and not volume of business done during 1953, and do not include inventory or wholesale financing for distributors, dealers, and other retailers who sell on time, or industrial, commercial, or other business installment sale credit, it would be conservative to estimate that the aggregate volume of financing done in this country in connection with the time sale of goods is in excess of $50 billion a year.

The aggregate volume of business done by corporations which to a large extent depend ultimately on retail time sales to market their products is, of course, greater.

The productive use of manpower in the time-selling industry is, of course, tremendous. In the automotive field alone, in which it has been estimated that as high as 80 percent of inventory acquisitions are financed for dealers and approximately 60 to 65 percent of retail sales are financed on time, it has been estimated that approximately 8 million people are gainfully employed.

Since the complete structure of the time-selling industry rests solely and entirely on this time price doctrine, anything that would tend even so slightly to disturb or disrupt it ought to be most carefully avoided. A limitation on carrying charges restricting them to conventional interest rates would make it impossible for the time-selling industry to continue. It is readily apparent that without time selling mass consumption would be so considerably curtailed that mass production would have to be decreased to such a point that unemployment and prices would be permanently increased and our purchasing power diminished so that the economy of the country would be seriously and adversely affected. Section 163 (b) in its present form definitely tends to disturb this time-price doctrine. So as not to give, unintentionally, a wrong inference or implication, it is respectfully but most sincerely urged that there is an absolute necessity for a change in the language of the section as hereinbefore suggested.

IDENTITY OF THE WITNESS

The writer is a member of the law firm of Muecke, Mules, and Ireton, 1004 First National Bank Building, Baltimore 2, Md., and is of counsel to Commercial Credit Co. and its subsidiaries. The latter, in addition to its other activities, is in the business of financing nationwide the distribution, marketing, and retail time sale of industrial and commercial machinery and equipment and consumer goods of all kinds. The volume of such business done by said company and its subsidiaries in 1953 was slightly in excess of $3 billion.

(See additional statement, p. 2408.)

PEAT, MARWICK, MITCHELL & CO.,
New York, N. Y.

Re additional clause to subparagraph (d) (1) (C) of section 421, H. R. 8300, now under consideration by your committee.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SIR: Mr Thomas J. Green, partner of Peat, Marwick, Mitchell & Co., wrote the Ways and Means Committee a letter dated July 14, 1953, copy attached hereto. Exhibit 1, which appears on page 427 of part 1, with respect to topic 15, stock options and deferred compensation plans.

As a result of said letter to the Committee on Ways and Means, subparagraph (d) (1) (C) of section 421 was adopted in H. R. 8300, reading as follows:

Subparagraph (d) (1) (C) of section 421: "* * * This subparagraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted."

This provision does cover the situation as set out in letter to the Ways and Means Committee, in principle, but does not cover the situation entirely. There-

fore, in order to cover the situation presented, it will be necessary to strike the period and add "or is exercised within 1 year after the date of enactment of this title."

Such additional clause will cover the type of stock options where the option price is at least 110 percent of the fair market value and the uncertainty created by the regulations, which went far beyond the decision of the Supreme Court in *Commissioner* v. *Smith* (324 U. S. 177 (1945)), as the Finance Committee pointed out in its report No. 2375, where options were granted after February 26, 1945, the date of the *Commissioner* v. *Smith* decision, and prior to September 23, 1950, the date of the passage of the Revenue Act of 1950.

Very truly yours,

ALFRED C. FRODEL.

PEAT, MARWICK, MITCHELL & Co.,
New York, N. Y., July 14, 1953.

COMMITTEE ON WAYS AND MEANS,
New House Office Building, Washington, D. C.

GENTLEMEN: In connection with the current hearings before your committee on revision of the Federal tax laws, we are pleased to submit for the record certain recommendations and observations with respect to topic 15—stock options and deferred compensation plans.

Section 130A of the Internal Revenue Code which covers the treatment of employer stock options should, we submit, be amended by inserting at the end of section 130A (d) (1) a paragraph reading as follows:

"(D) *Provided, however,* the provisions of subparagraph (C) shall not apply if such option was granted after February 26, 1945, and prior to September 23, 1950, and at the time such option was granted the option price was at least 10 percent in excess of the fair market value at such time of the stock subject to the option."

The need for this amendment is, perhaps, best illustrated by an example which has been drawn to our attention.

In 1939 a "family group" (consisting of four brothers and their families) acquired a controlling interest of slightly over 50 percent in company A. Some time thereafter company A acquired company B through an exchange of stock. The "family group" had owned and operated company B for some years. This increased their controlling interest in company A, and as of August 31, 1948, the combined holdings of the "family group" represented 58.46 percent of the total outstanding common stock of that company.

During the period there had been some expansion of the company's operations, financed primarily out of retained earnings or borrowed moneys.

On August 31, 1948, options were granted to the four brothers each to purchase 10,000 shares of common stock of company A at $25 per share. Such options were exercisable over a period of not less than 5 years and not more than 10 years. On the date the options were granted, the over-the-counter market on these shares was $21.50 bid, $22.25 asked, or a mean of $21.88. For the calendar year 1948 the range of the market was $22.50 high, $10 low, and $20 last. Thus the option price was approximately 15 percent above the market value of the shares on the date the options were granted. These options were granted only after thorough discussion with and approval by the principal minority stockholders.

At the time the options were granted, these important minority stockholders were desirous of further expanding the operations of company A, and it was expected that to accomplish this it would be necessary to issue additional common stock to raise cash for the purpose of acquiring related businesses. That, however, would have resulted in a dilution of the "family group" control, which has in fact happened, as at the present time the members of the said "family group" own only 43.89 percent of the outstanding common stock. However, through the issuance of the options the "family group" was put in position to reestablish their actual control of the corporation through the exercise of the options. They were not issued as a means of compensation (which is taken care of through a profit-sharing bonus arrangement) or to effect a distribution of earnings, something which the substantial minority interest would not have permitted in any way, but merely as an incentive to expand the business without losing control of the company.

When the law was amended in 1950 no clear provision was made for the proper treatment of options issued during the uncertain period from 1945 through 1950 which did not happen to comply with the amendment as it was later enacted in 1950.

The 4 brothers have, ever since 1939, served full time in the direct management and operation of the business.

When section 130A was enacted it was specifically limited to optionees who, with their families, held less than 10 percent of the employer-corporation stock. The regulations or rulings prior to the enactment of section 130A never imposed the 10-percent ownership limitation, and the imposition of such limitation in section 130A should not be applied retroactively. The effect of the amendment now proposed is only to lift the 10-percent stock ownership rule from options granted after February 26, 1945, and prior to September 23, 1950, and only in cases where the option price was at least 10 percent in excess of the fair market value of the option stock at the time the option was granted. Thus the proposed amendment would apply only in cases complying fully with the intent of the amendment as stated in the Finance Committee report No. 2375, which said:

"Ordinarily when an option is used as an incentive device, the option price approximates the fair market value of the stock at the time the option is granted."

Furthermore, the effect of the proposed amendment would be to accord the options issued during the period of uncertainty substantially the same treatment as accorded by the Bureau of Internal Revenue to options granted on or before February 26, 1945, as set forth in IT 3795, CB 1946-1, page 15.

The Finance Committee, in its report No. 2375, stated:

"At the present time the taxation of these options is governed by regulations which impede the use of the employee stock option for incentive purposes. Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v. *Smith*, 324 U. S. 177 (1945). The resulting uncertainty as to whether these regulations are in accordance with the law is an additional reason for legislative action at the present time."

While the enactment of section 130A laid down definite rules and removed the uncertainty for the future, it did nothing to clarify the status of options granted during the period of uncertainty referred to in the Finance Committee report.

The amendment proposed would not affect options granted after the enactment of section 130A, September 23, 1950. It is also consistent with the declared purpose of not penalizing incentive devices or impeding their proper use for incentive purposes. It was said in the Finance Committee report No. 2375:

"At the present time the taxation of these options is governed by regulations which impede the use of the employee stock option for incentive purposes."

Further, the proposed amendment is consistent with the principle adopted in section 130A which recognizes that the higher the option price when granted, in relation to market value, the more evident it is that the option is not being improperly employed. It adheres to that principle because it applies only if the option price when granted exceeds the then market value by 10 percent or more.

Very truly yours,

THOMAS J. GREEN, *Partner.*

STATEMENT BY THE BLUE CROSS COMMISSION URGING REVISION OF SECTIONS 104 AND 105 OF THE INTERNAL REVENUE CODE OF 1954

CHICAGO, ILL., *April 27, 1954.*

The COMMITTEE ON FINANCE,
United States Senate,
Washington, D. C.

GENTLEMEN: The Blue Cross Commission of the American Hospital Association, speaking for the Blue Cross plans of the United States, urges the revision of sections 104 and 105 of the Internal Revenue Code of 1954 (H. R. 8300, 83d Cong.) to eliminate the requirement that employer accident and health plans must be "qualified plans" to obtain tax exemption for the recipients of hospitalization and medical benefits. The position of the Commission relates only to these hospitalization and medical benefits. No opinion is expressed as to compensation for loss of wages.

Sections 104 and 105, and the related section 106, are, in general, new to the code and have two major objectives:

1. The first objective of these sections is legislatively to confirm what is the present administrative practice with respect to hospitalization and medical plans. This practice is and has been to the effect that no income-tax liability shall accrue to employees by reason of employer contributions to accident or health plans for personal injuries or sickness (sec. 106). The provisions in the bill

follow the recommendation of President Eisenhower in his budget message to the Congress of January 22, 1954, when he said.

"Insurance and other plans adopted by employers to protect their employees against the risks of sickness should be encouraged by removing the present uncertainties in the tax law. It should be made clear that the employer's share of the costs of providing such protection on a group basis will not be treated as income on which the employee is liable for tax. This principle should be applied to medical and hospital insurance as well as to a full or partial continuation of earnings during a sickness."

2. The second objective of the proposed statutory provisions appears to spring from some feeling of need to qualify the first objective. Section 104 of the bill includes a provision taken directly from section 22 (b) (5) of the present code (which has been contained in the Internal Revenue Code unchanged since 1918). Section 104 of the bill and section 22 (b) (5) of the present code both provide that amounts received through accident or health insurance as compensation for personal injuries or sickness shall be exempt from taxation A new provision is contained in section 104, however, to the effect that to the extent that such compensation is attributable to contributions made by the employer (which contributions were not includible in the taxable income of the employee), it shall be exempt from tax only if received by the employee under a "qualified employer's accident or health plan." This term is defined in section 105 (c) (1) by series of provisions, and by a cross-reference to the provisions of section 105 (e) which relates to employee's pension trusts. The definition of a "qualified employer's accident or health plan," as stated in these two sections, 105 (c) and 501 (e), can fairly be described as of a lengthy, highly complex and technical nature.

The provision that the employee shall not be taxed on employer contributions is sound and constructive, and is in accordance with administration policy as stated by the President. The provision clarifies a situation as to which there has been considerable discussion, although no administrative attempt has yet been made to impose such a tax. However, in linking this provision (sec. 106) with the new sections 104 and 105 two highly objectionable results appear to have been achieved.

First, the hitherto unqualified exemption from tax of benefits received for personal injuries or sickness has been modified. The result—if the modification has any effect—is to impose a large tax at the moment of impact of injury or sickness. To state a simple example: If an employee whose health insurance has been purchased by his employer incurs a $1,000 bill for hospital and medical expenses which is met by the insurance the employee will be taxed on the $1,000 as taxable income. As a result of an unavoidable misfortune, from which he receives no benefit other than the mitigation of his expenses and losses, he will be presented by the Federal Government with a bill for several hundred dollars or more for income taxes. A more unfair and unfortunate result would be hard to imagine.

Secondly, to obtain exemption from this unfair and unfortunate tax, it is required that the plan under which the employer contributes to the costs of health insurance be a "qualified plan." It has been stated to representatives of the Blue Cross commission that all employer plans in which they participate will in all likelihood meet the requirements laid down for a qualified plan. In fairness, it must be said that probably this is true. However, the conclusion that a plan is qualified can only be reached with any certainty by the analysis of an extremely complicated set of new statutory provisions and their application to myriad varying complicated fact situations.

The Blue Cross plans presently provide hospital benefits for over 43 million people in the United States. A current survey covering 92 percent of Blue Cross enrollment, indicates that of an aggregate of 303,630 employee groups, 51,930 (17 percent), have employer contributions. Of the 28,850,680 employees and their dependents in these groups, 9,922,530 (34 percent), benefit from contributions by the employer. These employee groups range from the very large industrial companies, such as U. S. Steel and General Motors Corp., to a vast number of small businesses which often employ as few as 5 or 10 employees. As to the large companies with skilled and experienced legal and personnel departments the analysis of the new statute and its application to the employer's plan probably involves not too great an additional burden. But as to the innumerable small employers' plans any such analysis and consideration is in fact a practical impossibility. The mere suggestion that these informal simple arrangements involve questions of tax liability is bound to be a serious deterrent to the making

of such arrangements, in direct contravention of the objectives stated by the President. If, in addition, it is required that the Internal Revenue Service rule upon the qualification of such plans, as is the case with present pension plans, the deterrent would probably become an almost insurmountable obstacle. It may be added that in view of the thousands of plans in existence, the requirement of an administrative ruling on each plan would place a great burden upon the Internal Revenue Service.

To ask the various Blue Cross plans (and the insurance companies) to train special personnel to make these involved legal explanations to the various employer and employee groups is in itself a requirement wholly disproportionate to whatever gains might be achieved by these provisions.

We believe that there is in fact no reasonable chance of abuse of these arrangements for hospital and medical benefits which would require such complicated and drastic preventive measures, or which, in the broad framework in these situations, requires any new preventive measures whatever. Under present law and administrative practice no tax is imposed in these situations, under any circumstances. We have heard of no evidence of abuse of the present provisions. It seems extremely unlikely that the exemption has been or will be used to accomplish any unfair or unequitable tax exemption on the part of corporate executives or other high income corporate employees. Benefits from voluntary prepayment plans and insurance for hospital and medical care are for the most part limited to the amount of hospitalization, surgical, and medical charges. These are matters almost totally beyond the control of the recipients. As voluntary prepayment rates and insurance premiums are determined actuarially on the very broad base of the average incidence of illness and accident, the rates and the benefits are not subject to distortion or manipulation in favor of high income corporate executives. The forces which determine benefits and rates in all cases favor the low-income employee. He will, proportionately, receive more benefits, and his employer will make a payment upon his behalf which is a higher proportion of his salary than will be the payment made on behalf of the higher salaried executive. Illness and accidents are no respecters of persons. The chance of disproportionate benefits or discrimination in favor of key executives is believed in fact to be negligible.

Against this background, and in the absence of any showing of real abuse of the present complete exemption which has no requirement for the qualification of plans, the imposition of these technical and complicated requirements of qualification on a growing and socially desirable system of hospital and medical benefits and insurance can only be regarded as most unfortunate.

Our specific suggestion is that section 104 (a) (3) be revised, at least so far as hospital and medical benefits are concerned (and beyond that we express no views), to restore the simple long-established provisions of section 22 (b) (5), by the elimination of the parenthetical material, as follows:

(3) "amounts received through accident or health insurance for personal injury or sickness [(other than amounts received by an employee, to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee)]; and"

A related simplification or elimination of section 105 will then be in order, depending upon whether the concept of "qualified employer's accident or health plans" should be retained in the code to meet possible discriminatory arrangements under the loss of wages provisions.

It should be noted that the report of the Committee on Ways and Means of the House of Representatives, March 9, 1954, House Report No. 1337, in discussing these provisions, indicates that the only specific abuses to which they are directed are in connection with loss of wages. See page 15 of the General Statement (beginning on p. 1) and pages A32, A33, A34 of the detailed discussion of the technical provisions of the bill, beginning on page A1.

The Blue Cross commission of the American Hospital Association is the coordinating agency for the Blue Cross plans of the United States (as well as for the five Canadian Blue Cross plans). Coverage of the plans has grown with amazing rapidity, from approximately 4,500,000 in 1940 to 16,500,000 in 1945, and to over 43 million at present. The achievements and objectives of these plans have repeatedly been endorsed by leaders of the administration, including the President, and by Members of this Congress. These plans, together with private insurance, constitute the great hope of solving the Nation's problems of financing hospital and medical care on a voluntary, nongovernmental basis. They deserve, we believe, the full support of the American people, and of the Congress.

The revision of sections 104 and 105 to remove the obstructive effect of the "qualified plan" requirements is, we submit, a necessary step to aid the growth of voluntary prepayment plans and insurance for hospital and medical care.

Respectfully submitted.

THE BLUE CROSS COMMISSION OF THE AMERICAN HOSPITAL ASSOCIATION,
By ABRAHAM OSEROFF, *Chairman.*

Counsel:
RANDOLPH E. PAUL.
BENJAMIN H. LONG.
CAROLYN E. AGGER.

ARTHUR ANDERSEN & CO.,
New York, April 27, 1954.

Subject: Revenue bill, H. R. 8300, section 1732, allocation of consolidated taxes.

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

DEAR SIR: As is stated in the discussion of consolidated returns XXIX-D of the report of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8300, the allocation of the consolidated tax takes on added significance because of the lowering of the affiliation test to 80 percent. The allocation of the consolidated tax has unusual significance in the case of utility companies where in the determination of rates the regulatory commissions only allow as a cost the portion of the consolidated tax assessed to the subsidiary company.

Hence, as a matter of equity to minority stockholders, rate payers, and investors, an equitable allocation of the consolidated tax is of major importance.

As we understand section 1732 of H. R. 8300, the first and third methods of allocating the consolidated tax do not recognize the carryback or carryforward provisions of the act that would be available to a company on an individual company basis. The second alternative recognizes these provisions of the act but does not eliminate intercompany dividends in the determination of the tax liability of the individual members of the group. We do not believe there should be a penalty—that is, that either loss of carryforwards and carrybacks, or of having to include intercompany dividends as income—in making a choice of allocation.

In the interest of equity in the allocation of the consolidated tax, the following matters should be considered:

(1) Dividends from companies within the group should be eliminated in determining the liability of individual companies, inasmuch as such dividends represent merely a transfer of funds within the group and do not enter into the computation of the consolidated tax.

(2) A reduction in tax resulting from loss companies should be retained by the parent company. (Equitably it represents compensation for the decrease in the value of the parent company's investments in such loss company (tax basis of investment is reduced by such loss) or is available to make the required payment of tax in a subsequent year if the subsidiary can use the carryforward provisions of the code.)

(3) A subsidiary company should not be assessed a higher proportion of the consolidated tax than the tax it would have had to pay as an individual company.

This method of allocation would produce an equitable distribution of the consolidated tax, having in mind the rights of minority stockholders, rate payers, and investors.

In order to accomplish this, we respectfully submit that the following, or language that would accomplish the same purpose, be inserted in section 1732 as an alternative method or as a substitution for the other methods:

"The consolidated tax liability shall be allocated to the several members of the group by assigning to each member other than the common parent an amount equal to the tax which such member would have paid had it filed a separate return for such year, except that intercompany dividends shall be eliminated in the determination of such individual tax. If the amount so assigned to members other than the common parent aggregates more than the consolidated tax liability, such excess shall be treated as a dividend received by such common parent in the year for which the tax was allocated. Further, if any member

other than the common parent would have had a net operating loss or capital loss carryover or carryback had it filed separate returns for prior years while a member of the same group, the tax allocated to such member shall be reduced and the tax allocated to the common parent shall be increased by the amount attributable to the carryover or carryback that would have been available to the subsidiary on an individual return basis."

It does not seem necessary to discuss further that intercompany dividends are not income to the consolidated group. It has previously been the practice of the Treasury Department to eliminate such dividends in the allocation of consolidated taxes.

Unusual and distorted results can obtain if, in the allocation of consolidated taxes, the rights of the subsidiary companies, on an individual company basis, to loss carrybacks and carryforwards are not recognized. An example is set forth in the attached schedule. As indicated therein, under present procedures the stockholders of the parent company get no benefit from losses of the parent company that are contributed to the consolidated return. Further:

(1) Subsidiary A that really broke even over the 2-year period reflects a net loss of $452 for the 2-year period.

(2) Subsidiary B which had nothing to do with the loss of subsidiary A and whose net income should have been $480 in each of the 2 years, reflects net income of $514 in the first year and $1,034 in the second year.

These variations and distortions would not result if the proposed rule, as set forth herein, is adopted.

Very truly yours,

ARTHUR ANDERSEN & CO.

Schedule showing fluctuations in net earnings resulting from allocations of consolidated Federal income taxes

	Holding company	Subsidiary A	Subsidiary B	Consolidated
Present method of allocating consolidated taxes (I. T. 4085)				
1st year				
Taxable income (loss)	($200)	$1,000	$1,000	$1,800
Consolidated tax		486	486	972
Net income (loss)	(200)	514	514	828
2d year:				
Taxable income (loss)	(200)	(1,000)	1,000	(200)
Tax		(34)	(34)	[1](68)
Net income (loss)	(200)	(966)	1,034	(132)
As tax would be allocated under proposed rule:				
1st year:				
Taxable income (loss)	(200)	1,000	1,000	1,800
Consolidated tax	[2](68)	[3] 520	[3] 520	972
Net income	(132)	480	480	828
2d year				
Taxable income (loss)	(200)	(1,000)	1,0[illegible]	(200)
Consolidated tax	[4](68)	[1](520)	520	[4](68)
Net income (loss)	(132)	(480)	480	(132)

[1] Benefit of loss carryback from previous year

[2] See the following:

52 percent of $200	$104
Less 2 percent of $1,800	36
Net	68

[3] 52 percent rate

[4] Due from Treasury Department resulting from loss carryback.

NOTE.—Parentheses indicate loss.

AARON, AARON, SCHIMBERG & HESS,
Chicago, Ill., April 28, 1954.

Re proposed Internal Revenue Code of 1954 (H. R. 8300)

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

(Attention: Mrs. Elizabeth Springer, Clerk.)

GENTLEMEN: We desire to direct attention to several provisions of the proposed Internal Revenue Code of 1954 which, in our opinion, will create hardships and inequities. Our comments are as follows:

(*1*) *Sections 275 and 312* (*c*) *and* (*d*)

(*a*) Section 275 provides for the disallowance as a deduction from income of any payments made with respect to nonparticipating stock, as defined in section 312 (d). The effect of section 312 (c) and (d) is to classify as nonparticipating stock (i) indebtedness of a corporation to persons who own 25 percent or more of the participating stock of the corporation which is subordinated to the claims of trade creditors generally and (ii) indebtedness of a corporation payments, if any, for the use of the principal amount of which are dependent in amount upon the earnings of the corporation and are not unconditionally payable at a date not later than the maturity date of the principal amount. The effect thereof is to disqualify as a deduction from gross income certain payments of interest made on subordinated indebtedness and of interest which is predicated on corporate earnings.

(*b*) Many corporations of small and moderate size are required, from time to time, to borrow funds which can be obtained only from shareholder sources and which obligations, due to demands of trade and other creditors, must be subordinated for repayment purposes to indebtedness due such other creditors. Although the purpose of section 275 is to deny such interest deductions for the reason that such subordinated loans might be considered at least temporary capital of the corporation and, to that extent, the interest payments are the equivalent of dividends, the section, in its present form, is discriminatory against small and moderate-size corporations. Larger corporations generally can more easily obtain commercial credit and have other financing advantages which are not available to small corporations. Although some safeguards may be desirable, it appears that the denial of the interest deduction should be limited to those cases in which the amount of subordinated debt bears an unduly large ratio to net worth.

(*c*) The denial of the interest deduction to payments of "interest" which are based on corporate earnings also is predicated on the similarity which exists, in some situations, between securities on which interest is payable out of earnings only and certain types of preferred stock. Many securities of this character are outstanding as a result of financing of long standing. The interest deduction, in many such cases, may be vital to the continued business existence of the debtor. Many issues of this character are publicly held. Denial of the interest deduction to such debtors could create financial disaster, particularly in cases in which refinancing is not practicable, either because of the public character of the outstanding debt or because of the current financial condition and borrowing potential of the corporation.

(*d*) Our attention has been directed to at least one issue of publicly held funded debt on which the interest obligations are both fixed and contingent. Under the provisions of the indenture relating thereto, fixed interest is payable by the corporation on established dates, none of which succeed final maturity of the principal debt. In addition thereto, the corporation is obligated, if its net earnings determined in accordance with the formula contained in the indenture, exceed a base amount, to pay contingent interest, which is graduated in amount predicated on the total amount of earnings for the fiscal period. A final payment of contingent interest is due contemporaneously with the final maturity of principal indebtedness and, for convenience, is established at the same rate of contingent interest, if any, as was paid on the last preceding contingent interest payment date.

Section 312 (c), as presently drafted, might be construed to disqualify as a deduction even the fixed-interest payments on the subject debt, as said section includes as securities only those with respect to which payments for the use of the principal amount borrowed are not dependent in amount on the earnings of the corporation. As the exact amount of interest payable on the subject debt may depend on the earnings of the corporation, the related sections 275 and 312

might be construed to deny the deduction. The issue involved is publicly held and refinancing is not practicable. Denial of the deduction could cause a great financial hardship.

Although there is some merit to denial of the interest deduction on debt which is similar in some respects to capital stock, it is our opinion that the standards established by the related subject sections are too meager. If it is important to deny the tax deduction for the purpose of closing a loophole, the denial should be limited to situations in which (*a*) the debt does not have a fixed maturity or (*b*) has voting rights. The denial should not be applicable to any portion of the interest which is fixed in character and the nonpayment of which constitutes a default permitting acceleration of the indebtedness and action to enforce collection thereof.

(*2*) *Section 353*

Section 353 of the proposed Internal Revenue Code contains the statement, as part of subsection (a):

"This subsection shall not apply to a distribution of stock or securities of a controlled corporation which was acquired by the distributing corporation within 5 years preceding such distribution in a transaction to which section 351 (relating to transfers to controlled corporations) is applicable."

The House Ways and Means Committee report with respect to section 353 contains the following statement:

"The rules of section 353 apply equally with respect to the distribution of stock of a newly created subsidiary, or an existing subsidiary, whether such subsidiary was previously acquired in a taxable or tax-free transaction."

As the mechanics for accomplishing a separation and distribution pursuant to section 353 and subsequent sections of part III might necessitate the formation by the distributing corporation of a controlled corporation pursuant to section 351 immediately prior to the distribution of the capital stock of the controlled corporation to the shareholders of the distributing corporation, there appears to be some inconsistency between the quoted portion of 353 (a) and the quoted portion of the House report. It is apparent that the quoted portion of the House report properly expresses the intention of the House Ways and Means Committee. Saving language should be inserted in section 353 (a) to eliminate the inconsistency.

Generally, with respect to section 353, it appears that the restrictions imposed on an inactive corporation are too severe. In our opinion, it would be desirable to provide less stringent restrictions.

(*3*) *Section 501* (*e*)

(*a*) Section 501 (e) (3) establishes the acceptable nondiscriminatory classifications for employees' trusts. The inclusion therein of rigid mathematical tests for determining whether a plan is discriminatory may render it impracticable for small and moderately sized corporations to establish such trusts. A corporation with relatively few employees in a group such as a salaried employees group might find it impossible to establish a nondiscriminatory plan without violating the limitation with respect to key employees even though the key employees are not shareholder employees. The effect, therefore, of section 501 (e) (3) may well be to render it more, rather than less, difficult to establish qualified plans. We question whether this was the congressional intention.

(*b*) Pursuant to the provisions of section 403 (c), the provisions of section 501 (e) are not applicable to trusts previously qualified under section 165 (a) and remaining so qualified. From time to time, it may be necessary for a taxpayer to amend the provisions of a trust previously qualified under section 165 (a). In our opinion, the applicable provisions of the new code should be clarified to render it unnecessary to qualify the trust under the provisions of the new code in order to effect such amendment. Otherwise, the Commissioner of Internal Revenue may contend that any amendment to an existing qualified trust requires compliance by the trust with all the qualification provisions of the new code.

(*4*) *Section 505*

(*a*) Section 505 (a) limits investments which may be made to a trust qualified for exemption under section 501 (e). These limitations prohibit a qualified trust from owning real estate in an amount greater than 5 percent of the total value of the trust assets. For practicable purposes, this provision may prohibit even a moderately sized employees trust from owning real estate, even though the ownership of real estate is a qualified investment under State law and,

in the judgment of the trustees, might be a most desirable investment for the trust. We already have experienced difficulty with this provision and have found it necessary to advise a bank, acting as an independent corporate trustee under an employees trust, to refrain from investing trust funds in real estate which would yield a good return to the trust and involve no risk. If it is desirable to retain a limitation on real-estate investments, the percentage factor should be substantially higher than 5 percent.

(*b*) Section 505 (a) also prohibits investments by trusts in annuity contracts or retirement income contracts in which the face amount exceeds 100 times the monthly annuity payable at normal retirement age under the plan. This provision conflicts with revenue ruling 54-51, which was issued by the Commissioner of Internal Revenue after prolonged consideration. In our opinion, the principle enunciated in revenue ruling 54-51 should be retained in the new code.

(*c*) Section 505 (b) (2) states:

"This section shall apply only to investments made after March 1, 1954, but all the assets of the trust shall be taken into consideration in determining whether an investment meets the conditions specified in paragraphs (6) and (7) of subsection (a)."

Whether this paragraph is intended to relate only to the denominator of the fraction used in determining the applicable percentage under paragraphs (6) and (7) or whether it is intended to have broader application is not clear. In our opinion, this paragraph should be clarified.

We will appreciate your consideration of the comments herein.

Yours very truly,

SIDNEY J. HESS, Jr.

HAUSSERMANN, DAVISON & SHATTUCK,
Boston 9, April 28, 1954.

Mrs. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR MADAM: Section 2503 of H. R. 8300 deals with the annual $3,000 gift-tax exclusion. In subsection (c) it purports to clarify the application of this exclusion to certain transfers for the benefit of minors.

As pointed out in the House committee report, the application of the future-interest rule under the 1939 code has been quite unsatisfactory as to gifts in trust for minors. From the very fact of the minority of the beneficiary it is important in such trusts that the trustee have broad discretion as to the payment of both income and principal for the minor's benefit, or to accumulate income when not needed; yet this essential flexibility has been held to create so uncertain a present interest in the beneficiary that the annual exemption (now exclusion) does not apply to the gift in trust. The technical justification for this result is clear enough under the 1939 code, although such a rule is most unfortunate since it tends to discourage the making of sensible trust provisions for minors.

The new subsection (c) referred to above purports to cure this defect in gifts for the benefit of minors "* * * if the property and the income therefrom will—

"(1) be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and

"(2) to the extent not so expended—

"(A) pass to the donee on his attaining the age of 21 years, and

"(B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint my will under a general power of appointment as defined in section 2514 (c)."

This is probably an adequate solution in those cases where it is desired that the gift become final when the minor attains the age of 21, but in my experience this is a relatively uncommon type of trust. With any substantial amount of property age 21 is seldom a satisfactory time for final distribution—with most of us the age of discretion does not arrive until later. Moreover, the rationale of the future-interest rule would seem to be adequately met if the code requires that accumulated income be distributed at age 21, or pass to the estate of the minor if he dies before that time, without any requirement that principal also be distributed at that time.

My recommendation can easily be carried out by adding at the beginning of clause (A) the following words, "any accumulated or undistributed income

will * * *." The same words also should be inserted in clause (B) after the words "21 years." As modified section 2503 (c) would read as follows:

"(c) TRANSFER FOR THE BENEFIT OF MINOR.—No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom will—

"(1) be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and

"(2) to the extent not so expended—

"(A) any accumulated or undistributed income will pass to the donee on his attaining the age of 21 years, and

"(B) in the event the donee dies before attaining the age of 21 years any accumulated or undistributed income will be payable to the estate of the donee or as he may appoint by will under a general power of appointment as defined in section 2514 (c)."

I hope your committee will give favorable consideration to such a modification of section 2503. For your convenience I enclose two extra copies of my letter.

Yours very truly,

PHILIP J. WOODWARD.

THE FARMERS & STOCKMENS BANK,
Clayton, N. Mex., April 22, 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR: It would seem to us that it is morally wrong to tax one business and not tax another business, especially when these businesses are in competition with each other. We are led to believe that about $1 billion of Federal revenue could be realized if we were to tax cooperative and mutual businesses on the same basis as their taxpaying competitors are taxed. The next income for the year 1952 of 25 major regional farm supply purchasing cooperatives totaled $38,207,167 on which they paid a tax of $2,440,815. Regular tax-paying corporations would have paid Federal income tax on this income of $19,735,715. Because of tax favoritism, $17 million was added to the tax burden of the taxpayers of the United States.

The top 300 savings and loan associations showed a gain in the United States of 18.46 percent for the year ending December 31, 1953, while the 300 top banks showed an increase of 1.46 percent for the same period. This gain is due to the tax advantage which the savings and loan associations have over their taxpaying competitors. As bankers, we have no way of competing with the savings and loan associations who advertise over the national broadcasting stations promising to pay a much higher rate of interest than we could possibly pay, and also offering premiums for new accounts.

The rapid growth of cooperative businesses in the United States presents a dangerous threat, not only to individual enterprise in this Nation, but also to our tax structure. The number of credit unions alone is increasing at the rate of 161 per month.

To cite a specific instance of how the savings and loan associations affect a community, we have to advise that one of our customers came into our office and stated that he planned to deposit $40,000 with a Federal savings and loan association in one of the large centers. The radio advertising which he listened to had led him to believe that he could leave his money on time deposit with the same type of insurance that he had at any bank, at an interest rate of 3 percent, when in reality he was being solicited for an investment in shares of stock instead of a time deposit.

If all businesses in the United States were run as cooperative businesses with the same tax-free privileges as the cooperatives enjoy, we are wondering what would happen to our Government without the revenue that it now receives from taxpaying businesses of the United States. We have no animosity toward cooperative businesses, but we believe that all cooperative businesses receiving the protection of our Federal Government should be required to support that Federal Government by paying taxes on an equal basis with their taxpaying competitors.

Respectfully submitted.

F. H. CHILCOTE, *President.*

CROUSE-HINDS CO.,
Syracuse 1, N. Y., April 27, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SIR: We wish to strongly recommend that section 309 of the proposed Internal Revenue Code of 1954, H. R. 8300, either be completely revised, representing in its present form an inequitable and punitive solution to the problem of the preferred stock dividend, or, at a minimum, be amended to eliminate its more obvious defects.

We should like to emphasize at this point that the enactment of this section in its present form, we are advised, would cause to be imposed upon this company a transfer tax of $442,000 representing 85 percent of the $520,000 presently outstanding preferred stock due to be redeemed within the next 4 years pursuant to the sinking fund provisions of the preferred stock agreement. The tremendous impact which such a tax would have on the company's general economic health, and its planned expansion program, raises a serious question in the taxpayer's mind as to whether this section is not at cross-purposes with the efforts being made to encourage industrial activity and maintain employment. Section 309 is directed, in its effect, at the recent decision of the Court of Appeals for the Sixth Circuit in *Chamberlin* v. *Commissioner* which held that in a situation where a stock dividend of preferred on common is issued and shareholders immediately thereafter sell the preferred to an insurance company, and the stock is redeemable in a relatively short period, the gain on the sale of the preferred by the shareholder will be capital gain income rather than ordinary income. The Commissioner in the Chamberlin case contended that the preferred stock dividend was taxable as ordinary income on the grounds that the preferred stock dividend was equivalent to a cash dividend because of the prearranged sale with the insurance companies and the period of redemption—7½ years; also, that the prearranged sale resulted in a change in the proportionate interests in the corporation. The court held, however, that the legal effect of the dividend is determined at the time of its distribution, not by what the stockholders do with it after its receipt. The dividend here, being simply one of preferred stock paid on common with no preferred previously outstanding, has been held nontaxable in *Strassburger* (318 U. S 604), and other related decisions of the United States Supreme Court.

In all of the cases which the Treasury has litigated on the matter, the question always has been one of ordinary income versus capital gain income. The Treasury has contended that via a preferred stock dividend a shareholder was able to "bail out" earnings from the corporation at capital gain tax rates, rather than the ordinary income rates applied on distributions of earnings. If it be the intention of the Congress to enact a law which would uphold the Treasury's position, why does it not look to the result long sought by the Treasury rather than an indirect unrelated approach, namely the imposition of a penalty tax on the corporation, as set forth in the proposed section 309 (a) below:

"309 (a) IMPOSITION OF TAX.—There shall be imposed upon the transfer of securities or property by a corporation in redemption of nonparticipating stock within 10 years from the date of its issuance, a tax equal to 85 percent of the aggregate of the amount of money and the fair market value of the securities or property other than money so transferred. * * *"

It is our opinion that in lieu of section 309 as presently drafted, a completely revised section containing, in essence, the following provisions, would be more equitable and certainly more consistent with the Treasury's philosophy over the long period that it has been attempting to deal with the problem:

"1. The gain or loss on sale or redemption by the original shareholder of nonparticipating stock issued as a stock dividend or in connection with a recapitalization shall be treated as gain or loss on the sale of a capital asset if—

"(a) the sale or redemption by the original holder occurs at a date 10 years or more from the date of issuance.

"(b) redemption by the original holder is prior to 10 years from the date of issuance but is made under a sinking fund arrangement calling for the redemption of not in excess of 5 percent per annum of the original issue.

"2. Where the sale or redemption does not comply with 1 (a) or 1 (b) above, the original holder on sale or redemption shall report as ordinary income or loss

the difference between the amount realized on sale or redemption and the basis apportioned to the stock on its issuance, except as to—

"(a) Liquidations.

"(b) Corresponding redemption of participating stock.

"(c) Distributions not considered to be in redemption.

"(d) Redemption to pay death taxes ((a), (b), (c), (d) are essentially the same circumstances as those set forth in 309 (a) (1), (2), (4), (5)).

"3. This section shall apply only with respect to nonparticipating stock issued after the date of the enactment of this bill."

A separate section should deal with nonparticipating stock issued for securities or property, and there should also be a section dealing with gifts by the original holder of nonparticipating stock and their ultimate sale or redemption.

The revised section drafted along the lines set forth above, would be preferable to the proposed section 309 for the following reasons:

1. The tax, at ordinary income rates, would be imposed on the recipient of the benefit; under section 309, the tax at the punitive rate of 85 percent of the money or property transferred on the redemption would be imposed on the corporation and indirectly on the then holders of the common stock, which, in certain instances, as is true in the instant case, are parties other than the holders of the common stock at the time of the issuance of the preferred stock dividend. In 1946 at the time of the issuance of the preferred, this company had only 19 stockholders, while today the stockholders number close to 65. The proposed section 309 would impose a tax indirectly on a large number of shareholders who were not parties to the original transaction which the proposed new law is really seeking to tax. This attempt to tax retroactively by means of an excise tax on the corporation at the time of redemption is an inequitable solution to the problem—it is an attempt to circumvent the many decisions of the Supreme Court which held such distributions to be nontaxable. If its effect were limited to the original parties to the preferred stock distribution, the principle involved would nevertheless be offensive enough to call for its rejection. Since its effect will not be so limited, but may be imposed upon entirely innocent (and unsuspecting) third parties who acquired an interest in the company subsequently, the proposed section 309 is iniquitous and must be eliminated by the Senate Finance Committee.

2. By following our suggested revision, the Supreme Court holding on the nontaxability of a preferred on common dividend would remain the law, and Congress would be legislating only with respect to the nature of the income to be reported on the disposal by the original shareholder. It would serve to effectively close the door to the so-called bailout, yet it would be consistent with the opinions of our Supreme Court. There would appear to be little doubt as to the constitutionality of legislation, which would tax the gain on the sale or redemption (not the stock dividend) as either capital gain or ordinary income depending on the holding period of the stock and certain other factors set forth in our recommendation.

3. Under our recommendations, the ordinary tax on the gain on sale or redemption by the original holder would be imposed only with respect to nonparticipating stock issued after the date of the enactment of the bill. This would be far more equitable, for reasons to be discussed later, than the proposed section 309 which would tax at 85 percent the property or securities transferred in redemption of nonparticipating stock occurring prior to January 1, 1964, and thereafter such stock as was issued and outstanding for less than 10 years.

4. Our recommendation takes into consideration the sound business purpose behind a reasonable sinking fund arrangement. Such arrangements result in a part of earnings being devoted to the retirement of senior securities rather than the payment of dividends to common shareholders. The strengthened capital structure of the company enhances its ability to finance expansion of production and payrolls through issuance of new senior securities as opportunities present themselves. The failure of the proposed section 309 to recognize the desirability of sinking fund arrangements as a sound financing approach to preferred stock redemption was an important oversight.

In the event that the Senate Finance Committee cannot see its way clear to a complete revision of section 309, the following alternatives are suggested as mitigating, in part, the unreasonable impact of the section as it is now drafted.

First alternative

Section 309 should be amended to include a provision that the 85 percent transfer tax will not be imposed where the nonparticipating stock redeemed was

issued prior to January 1, 1954, and such redemption is pursuant to a standard sinking fund arrangement adopted at the time of the issuance of such nonparticipating stock; and that the period over which the redemption is to be made should not be less than 15 years, except in cases of complete liquidation, etc., discussed earlier.

The above amendment would prevent discrimination against this company which prior to January 1, 1954, declared a preferred on common dividend, not having in mind a bailout but rather a legitimate sound and necessary business purpose. Obviously, the taxpayer seeking a bailout would have long since redeemed the stock having provided for a very short redemption period.

In a Treasury ruling obtained September 19, 1946, the Commissioner of Internal Revenue ruled that the exchange of preferred and common for common outstanding, a recapitalization, would not be a taxable transaction and the basis of the old common should be apportioned to the preferred and common received on the exchange. The application for the ruling set forth clearly the purpose of the recapitalization and the plan of redemption, calling for retirement over not more than 15 years. The Treasury gave no indication in the ruling that there would be any possibility as to a later imposition of a transfer tax of the type now proposed. In reliance on the Treasury ruling the company carried out its proposed reorganization and has to this date complied with all the terms of the agreement as set forth in the application to the Treasury. It seems highly inequitable that at this time the company, on redemption of the remaining outstanding preferred stock issued in 1946 and redeemed pursuant to a sinking fund arrangement then adopted, should be subjected to this unreasonable transfer tax.

We recommend that the Senate Finance Committee give serious consideration to the two factors set forth above, first, the issuance of the nonparticipating stock prior to January 1, 1954, and second, the redemption pursuant to a reasonable sinking fund arrangement adopted at the time of the issuance of the stock.

Second alternative

Section 309 (c) provides that nonparticipating stock shall be deemed issued on the date of issuance of such stock or January 1, 1954, whichever date is later. Section 309 (a) imposes the 85-percent transfer tax on any redemption of nonparticipating stock, not specifically excepted, within 10 years of the date of issuance. It follows that a stock dividend issued in 1930, redeemable in 1955, would be outstanding for a period of 25 years and yet could not be redeemed until January 1, 1964, without the imposition of the 85-percent transfer tax. Stock issued in May 1954 could be redeemed free of the penalty in 10 years. It was obviously the belief that a 10-year holding period prior to redemption would seemingly preclude a bailout. It is difficult to follow the logic which would compel the payment of a transfer tax on a redemption 25 years from the date of issuance when the proposed section 309 considers a 10-year deferral of redemption as providing a sufficient safety period.

In view of the above, it is recommended that, as a second alternative, proposed section 309 (c) be deleted and the 10-year period run from the actual date of issuance, as set forth in 309 (a).

In the case of this company, it is hoped that in the event section 309 (c) is deleted the present holders of the preferred stock can be prevailed upon to agree to a deferral of the sinking-fund payments and redemption until September 1956, the date the 10-year period will expire. The chances of obtaining such a voluntary deferral agreement is much greater where only a 2-year moratorium is requested, rather than a required 10-year delay in redemption which would be necessary if section 309 (c) is retained.

Third alternative

The third alternative which we have to recommend, representing less than a major revision, would call for the imposition of the transfer tax on redemptions only with respect to nonparticipating stock issued after January 1, 1954. The reasons for this recommendation are set forth below:

1. The door to all future so-called bailouts will be closed as to new issues. Since the tax law under which issues prior to January 1, 1954, were made was such that the Supreme Court held such distributions to be nontaxable to the recipient, it would appear only reasonable that such parties should be in all equity protected by the Court's interpretation of the law at the time the transaction was entered into.

2. In many instances the original shareholder who received the benefit will no longer be the party upon whom, indirectly, the transfer tax on redemption will be imposed.

3. It will not be necessary for the Treasury and the taxpayer to incur considerable expense in exhaustive studies of the circumstances surrounding the issue of presently outstanding nonparticipating stock, particularly in instances where the issue has been outstanding for many years. The provision that calls for the imposition of the tax on the excess of the redemption price over 105 percent of the securities or property received on the issuance thereof would in many instances cause considerable record searching, most of which would prove unnecessary.

CONCLUSION

It is our sincere hope that the committee will recognize the need for an approach similar to that suggested in our principal recommendation. If not, certain of the more obvious inequities may be minimized by adoption of one or a combination of the alternatives set forth above.

Respectfully submitted.

A. F. HILLS, *President.*

INVESTORS DIVERSIFIED SERVICES, INC.,
Minneapolis, Minn., April 27, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I appreciate very much your gracious attention to the tax problems which I explained to you so briefly when I met you in the Senate anteroom on Thursday, April 22. Following your suggestion, I visited Mr. Stam's office. Unfortunately, he was attending a conference elsewhere at the time and I met with Mr. John B. Huffaker of Mr. Stam's office and Mr. R. G. Clark of the Treasury Department. I explained to them that I was appearing on behalf of holders of savings certificates issued by our companies (there are presently 350,000 of them altogether) and that face amount certificates, which have been such a popular medium for thrift and savings in the past, would in the future be adversely affected by the proposed section 1232. I stated further that I was clear in my own mind that this was an unintended result of some all-inclusive language in that proposed section. Mr. Huffaker and Mr. Clark readily understood the problem and asked that I submit a memorandum on the subject. I am today sending them such a memorandum and, for your information, I am enclosing a copy herewith.

I am also enclosing a memorandum, recommending a proposed amendment to section 505, wherein there seems to have been what, I think, must have been an inadvertent omission of face amount certificates as an eligible investment for pension trusts.

While in Washington I spoke to Senator Johnson and Senator Long, both members of the Senate Finance Committee, and I am sending copies of the memorandums to each of them. I plan also to send copies to Senator George, to whose attention I had planned to bring these problems, but whose illness prevented my doing so.

I shall very greatly appreciate your attention and that of the members of your committee to these problems which the proposed tax bill has created for the security holders of this company.

Very truly yours,

R. W. PURCELL.

RE AMENDMENT TO SECTION 1232 OF H. R. 8300—INTERNAL REVENUE CODE OF 1954

"Face amount certificates," as defined in section 2 (a) (15) of the Investment Company Act of 1940, are securities registered with the Securities and Exchange Commission and are issued and sold to the public by "face amount certificate companies," which are also defined and regulated by that act. Face amount certificates may be described generally as a means by which individuals adopt a plan of saving money and accumulate capital through installment payments over a period of years. At the completion of an individual's savings program a certificate matures for a fixed minimum amount, which is available to the holder all in the year of maturity. Prior to maturity a certificate at all times has a cash surrender value, which in the early years of the program is less than the

amount paid in by the holder, but which increases rapidly as the certificate approaches maturity. At maturity the holder may accept the full cash value of the certificate or he may elect to leave the proceeds with the company and receive interest payments currently (in which case the interest will be taxed as ordinary income). He may also extend the program for a period of years, continuing payments to the company during that period, or he may elect to accept payment in installments over a period of years. He may also combine two or more of these elective rights, accepting part of his proceeds in one manner and part in another. A sample 20-year face amount certificate issued by Investors Syndicate of America, Inc., is attached hereto, to which reference may be made for an exact and complete statement of the rights of the certificate holder and the obligations of the company.

Investors Diversified Services, Inc., and its subsidiary, Investors Syndicate of America, Inc., of Minneapolis, Minn., are the two largest face amount certificate companies in the United States. Face amount certificates in the amount of approximately $1,600 million, issued by these 2 companies are presently outstanding and owned by approximately 350,000 holders located in nearly every State in the United States. The average holding is approximately $5,200. These certificates are purchased by the public on the installment plan (usually on monthly or quarterly installments) and have maturities ranging from 6 to 20 years. Over 88 percent of these certificates have original maturities of 15 years or longer. Thus it will be seen that face amount certificates are primarily designed for and used by persons of small means to accumulate modest sums of money through a planned program of thrift.

Face-amount-certificate companies (as distinguished from life-insurance companies) pay full corporate income taxes. Holders of face amount certificates at maturity have heretofore been taxed on the gain at long-term capital gains tax rates. See the case of *Commissioner of Internal Revenue* v. *George Peck Caulkins*, 144 F. (2d) 482, decided by the United States Circuit Court of Appeals, Sixth Circuit, July 24, 1944, and asquiesced in by the Commissioner of Internal Revenue on December 25, 1944. This case held the certificate to be under the purview of section 117 (f) of the Internal Revenue Code.

Section 1232 of H. R. 8300 (proposed Internal Revenue Code of 1954) would, it is believed, alter this tax treatment so that holders of face amount certificates would be required to report the increment as ordinary income all earned from the year the certificate matures, irrespective of the exercise by such holders of one or more of the elective rights contained in the certificates. It is clear from an analysis of section 1232 that the tax treatment of the proceeds of face amount certificates was not considered or contemplated by the authors of section 1232 because its language throughout is primarily applicable to bonds or other evidences of indebtedness purchased at a discount, wherein the purchaser pays in full at the time of original issue and the obligation matures for a fixed amount at a date certain. Nevertheless, because of the broad applicability of section 1232 (a) (2) (A), it is believed that the tax treatment of face-amount certificates would be altered to the detriment of certificate holders. Accordingly, it is proposed that section 1232 (a) (2) (B) be amended to read as follows (new matter in italic):

"(B) *Exceptions.*—This subsection shall not apply to obligations the interest on which is not included in gross income under section 103 (relating to certain governmental obligations); *nor to face-amount certificates as defined in section 2 (a) (15) of the Investment Company Act of 1940, and which meet the standards of section 28 of said act.*"

REASONS FOR SPECIAL TAX TREATMENT

(1) It would afford the certificate holders the same tax treatment as in the past.

(2) If the gain on the certificates were treated as ordinary income at maturity or retirement, there would be a bunching of income, which has accumulated over a 15- or 20-year period, into 1 single year, resulting in a higher tax bracket which would create an inequitable result.

(3) This problem is recognized in connection with pension trusts as any payment received within 1 taxable year after retirement by the employee is taxed as a long-term capital gain (sec. 402 of H. R. 8300), whereas if retirement income is taken over a period of years it is taxable as ordinary income.

(4) The certificate is not a tax-avoidance scheme, such as might be the case of discount bonds and debentures, which section 1232 of H. R. 8300 is intended to correct.

(5) The language does not apply to certificates purchased in installments and for many reasons it would be impractical, if not impossible, to apply the section to face-amount certificates. Following are some of the reasons:

A. The definition of "issue price" can hardly apply—certainly with clarity—to the sale of face-amount certificates purchased on the installment plan. The cost to the purchaser varies, depending upon whether he pay monthly, quarterly, or on some other periodic basis. He may vary his method of payment from time to time, thus altering his cost. While these certificates are registered with the Securities and Exchange Commission, there is not an "initial offering price to the public" that can be definitely earmarked and determined. A certificate may be purchased by an individual upon the payment of the first installment in his program. Query: Might not this be held to be the "issue price"?

B. If one cannot readily determine the issue price, then, of course, the "original issue discount" is equally indeterminable.

C. The "date of original issue," as defined in the bill, means the date on which the issue was first sold to the public. These certificates have been sold to the public ever since 1941 following the enactment of the Investment Company Act of 1940. Is that the date from which one should compute the original issue discount or is it some other date?

D. Complicated problems would arise, due to the fact that under the terms of the face-amount certificates, cash surrender values are low in the early certificate years and increase rapidly as the certificate nears maturity. Under these circumstances, it would be unjust to require amortization of a theoretical discount, particularly in the case of a certificate sold or transferred from the original purchaser to a subsequent holder.

For these, among other reasons, it is clear that the applicability of section 1232 to face amount certificates would create nearly hopeless problems of a technical, administrative, and interpretative character both for the certificate holders and the Treasury Department.

CONCLUSION

It is respectfully submitted that this amendment should be incorporated in section 1232 of H. R. 8300:

(*a*) For the reasons above cited, section 1232 would apply inequitably to face amount certificate holders and would lead to difficult and complicated administrative and interpretative problems;

(*b*) Purchase of these certificates should be encouraged by the Government as an effective means by which hundreds of thousands of citizens have engaged in habits of thrift;

(*c*) Face amount certificate companies pay a 52 percent tax on net income (as distinguished from life-insurance companies) and the revenue to the Government is derived at the corporate end rather than the individual end of the transaction. It is believed that governmental revenues will in no way be impaired by this amendment. Certainly this is true for the near future, as the encouragement of this type of investment will yield greater corporate income taxes, and the proposed change from capital gains to ordinary income treatment for the holders would only yield additional tax revenue during somewhat distant future years.

Respectfully submitted.

INVESTORS DIVERSIFIED SERVICES, INC.

MINNEAPOLIS, MINN.

Representing 350,000 holders of face amount certificates.

RE AMENDMENT TO SECTION 505 OF H. R. 8300, ALLOWABLE INVESTMENTS FOR EMPLOYEES' TRUSTS

Section 505 (a) of H. R. 8300 contains provisions which control the allowable investments for employees' trusts. Certificates issued by a face amount certificate company, as defined in section 4 (1) of the Investment Company Act of 1940, are not specified as allowable investments for an unrestricted portion of trust assets.

We recommend that section 505 (a) (5) of H. R. 8300 be amended as follows, so as to allow the unlimited investment of trust funds in face amount certificates (new matter in italics):

"(5) securities of regulated investment companies (as defined in sec. 851); *or certificates issued by a face amount certificate company as defined in section 4 (1) of the Investment Company Act of 1940.*"

1. Face amount certificates are securities duly registered with the Securities and Exchange Commission and represent fixed obligations of the issuing corporation to make a definite minimum payment or payments at times and under conditions specifically set forth in the certificates. They provide for a fixed minimum yield, a flexible maturity, a cash surrender value at any time, and optional methods of distributing the proceeds, including periodic payments, over a specified number of years. These features make face amount certificates particularly adaptable for use in employees' pension trusts. Face amount certificates are currently in use as a medium for investment by many pension trusts.

2. The House Ways and Means Committee intended in this section to require the diversification of pension trust fund investments. In this connection, provisions are made for unlimited investments in the securities of regulated investment companies or retirement income contracts. The certificates issued by face-amount-certificate companies are comparable to each of these investments, and there is no apparent reason for limiting investment in such certificates.

3. Face-amount certificates are particularly adaptable for use in employees' trusts because they provide (*a*) a fixed yield; (*b*) long maturity; (*c*) liquidity; and (*d*) optional methods of distribution, including periodic payments for as long as 20 years.

4. A face-amount-certificate company is an investment company registered with the Securities and Exchange Commission. It is not, however, a "regulated investment company," as defined in section 851 of the proposed Internal Revenue Code. Nevertheless, the securities which it issues should be as eligible for investment by pension trusts as the securities of regulated investment companies or retirement income contracts issued by insurance companies. The investments made by face-amount-certificate companies are themselves diverse and regulated by laws pertaining to investments by life-insurance companies. (The Investment Company Act of 1940 specifically provides that face-amount-certificate companies must invest assets equal to their total certificate liabilities in accordance with the laws of the District of Columbia relating to life-insurance companies.)

We are attaching a specimen copy of a series A fully paid face-amount certificate, which is issued by this company and which is currently being purchased by pension trust funds.

Respectfully submitted.

INVESTORS SYNDICATE OF AMERICA, INC.

MINNEAPOLIS, MINN.

SAN FRANCISCO 8, CALIF., *April 27, 1954.*

Re H. R. 8300, Revenue Code of 1954, section 175, soil and water conservation expenditures.

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

DEAR SENATOR MILLIKIN: Should not the following wording, wherever written in the above captioned section, to wit: "which are not chargeable to capital" be changed to "which the taxpayer hereunder may elect not to charge to capital account"?

Since the intent seems to be to permit certain items of expenditures which were formerly chargeable to capital account, now, under this section, to be chargeable, up to 25 percent of gross farming income, to current deductions, it appears that the wording should be clarified as above indicated to avoid unnecessary possible controversy.

Another provision in the section which confuses me is the following:

"The term 'land used in farming' means land used * * * before or simultaneously with the expenditures for the purposes of water conservation and erosion * * *."

It is not clear to me whether a farmer who goes on land and brushes and levels it, and then proceeds to cultivate and plant a crop thereon, would be allowed to deduct those expenditures for the preliminary brushing and leveling, as being simultaneous with the farming, since the brushing and leveling come before the farming. Strictly speaking, they are not simultaneous, but it would seem those expenditures for brushing and leveling, for the purpose of soil and water conservation, should be included as deductible expense.

Do you think I should write also to some other Member of the Senate or House, in this connection, or do you have any suggestion in the matter?

Very respectfully yours,

A. A. TISCORNIA.

By the Federal Taxation Committee of The Detroit Board of Commerce—Recommendations on Federal Taxation

H. R. 8300—An act to revise the internal revenue laws of the United States

PREAMBLE

The proposed Internal Revenue Code of 1954, H. R. 8300, represents the first major revision of the Internal Revenue Code since the turn of the century and the enactment of the income tax. It is a monumental accomplishment, and Congressman Reed, members of the Joint Committee on Internal Revenue taxation and the various legislative and administrative committees who participated in this work deserve high praise for the job they have done.

In reviewing H. R. 8300, the Detroit Board of Commerce Federal Taxation Committee has made recommendations for technical changes in certain sections and subchapters of the law. Your committee believes these changes, if adopted, will assist in the administration of the laws and provide a more equitable treatment for taxpayers.

Many have said that H. R. 8300 is a big-business bill. This statement is not warranted. The United States Treasury Department, in the event the bill passes in its present form, will perhaps collect more tax money than they are collecting under the present code. The advance-payment requirements for corporations actually constitute an increase in the tax rate by 10 percent a year until 1960—by then the figure will reach 50 percent. It is difficult for members of the board's taxation committee to see how any benefit can be derived from the advance payments unless a corporation liquidates and goes out of business. Incidentally, when the first pay-as-you-go tax plan was adopted for individuals, there was a partial forgiveness of the first year's tax.

Section 461, which would initiate a new method covering the treatment of property taxes for Federal tax purposes, is another section of the bill that will penalize business millions of dollars in taxes in the first year it is operative.

Again we say, there are many good features to the proposed bill, but if the changes recommended herein are adopted, they will be of great benefit to the administrators of the law and the taxpayers. We respectfully urge the Senate Finance Committee and the Joint Congressional Committee on Internal Revenue Taxation, together with all other Members of Congress and the Treasury Department, to give the following recommendations serious consideration for adoption.

HERE ARE THE BOARD'S RECOMMENDATIONS

1. *Economy in Government.*—All nonessential spending should be eliminated to insure a balanced budget and prevent further erosion of the purchasing power of the dollar. More definitive programing of defense should provide an efficient defense establishment at monimum cost.

2. *Equal distribution of the tax burden.*—Corporate, individual, cooperative, and all other business enterprises, no matter how or by whom owned, should pay their proportionate share of the cost of government. Congress should carefully reconsider those sections of the Internal Revenue Code which grant tax exemptions to certain competitive business enterprises. Economic advantages and tax favoritism for certain competitive business groups should be eliminated.

3. *Individual income tax.*—The Board of Commerce is firmly of the opinion that everyone should pay some taxes. For this reason it is opposed to any increase in personal exemptions. However, it believes that as quickly as budget requirements permit, there should be a fairly substantial drop in the first bracket rate, and thereafter decreases in the rates of progression in order to benefit all taxpayers.

4. *Corporation tax rates.*—The proposed bill in effect increases the combined normal and surtax rates of corporations from 47 percent to 52 percent for 1 year to April 1, 1955. This increase of 5 percent is excessive. Normal and surtax rates should not exceed 50 percent for the year 1954, and 47 percent for next year as scheduled. As budgetary considerations permit, the rate should be reduced below 47 percent to the pre-Korean 38 percent rate level. The present excessively high rates tend to (*a*) stifle the incentive to produce; (*b*) encourage waste and

extravagance; (*c*) curtail expansion and growth, especially of small business; (*d*) reduce dividends and thereby the potential number of investors in corporations.

5. *Consolidated returns.*—The 2-percent penalty applicable to consolidated returns should be eliminated.

6. *Capital gains.*—The rate of capital gains tax should not be increased. No change should be made in the rate of tax or the holding period. Realization of capital gains is controlled by taxpayers. Any increase in rate or lengthening of the holding period will discourage sales, resulting in less rather than more revenue. We strongly oppose the lengthening of the holding period as applied to individuals who deal in real estate.

7. *Retroactivity.*—It is difficult to generalize as to the effective date of the proposed Internal Revenue Code. It is recommended, however, that sections of the code that tax transactions not previously taxable should not be made retroactive. The provisions designed to eliminate hardships or avoid inequities should apply, at the election of the taxpayer, to years ending after December 31, 1953.

Attention is directed to the following more important sections concerning which recommendations are made as to the effective dates of the new code

Subchapter C.—Section 391 (a): In order to permit consummation of transactions in an orderly course the effective date should be 90 days after enactment or January 1, 1955, whichever is later. Alternatively it may be desirable to grant an election to treat transactions occurring prior to 90 days after enactment under either the old law or the new code.

Section 505: The effective date of sections 503, 504, and 505 should be the date of enactment of the new code. These sections deal with certain prohibited transactions, unreasonable accumulations, and allowable investments and impose such limitations, for the first time, in respect of employees' trusts.

Subchapter N. At the election of the taxpayer, the provisions should be available for years ending after December 31, 1953.

8. *Intercorporate dividend.*—Section 243 of Revenue Code of 1954 makes no change in the 15-percent taxable portion of intercompany dividends received by one domestic corporation from another, except to change the 85-percent credit to a deduction—a minor simplification which may prove helpful in the event of a net-loss deduction or carryover.

The board of commerce considers this additional tax burden on intercorporate dividends as discriminatory, economically unsound, and unwarranted, and continues to recommend its complete elimination.

9. *Undistributed earnings—(Subchapter G—Part I).*—The law with respect to retained earnings should be changed to give allowance to management decisions regarding the portion of earnings to be retained for valid business reasons. Specifically, (*a*) the tax should apply only to that part of the undistributed net income which is unreasonably accumulated; (*b*) the parenthetical clause, "together with facts sufficient to apprise the Secretary or his delegate of the basis thereof" should be deleted from section 534 (c) of H. R. 8300.

10. *Payment date (secs. 6016, 6074, 6154, 6655).*—The payment of any part of the corporate tax should not be required in advance of the 15th day of the 3d month following the end of the taxpayer's taxable year. Specifically: (a) The bill makes a profound change in the method of payment of corporate taxes by corporations whose tax liabilities exceed $50,000 yearly requiring a 10-percent partial payment of estimated tax liability beginning in 1955 and increasing by 10 percent a year until 1959 when they reach 50 percent of the estimated tax for 1959. In 1960 and subsequent years corporation taxes will be due in four quarterly installments. The bill also provides penalties based on inaccurate declaration of estimated tax; (b) the Detroit Board of Commerce recommends strongly that these sections of the law as related to advance payments (6016, 6074, 6154, 6655) be deleted from H. R. 8300; (c) this provision of H. R. 8300 has the effect of increasing the tax rate of corporations by 10 percentage points for the year involved and the only manner in which a corporation can gain benefit from this section is when it goes out of business. In addition, the effect of the law could be disastrous on those industries which have widely fluctuating sales and profits in any taxable year.

The proposed acceleration of income-tax payments for corporations will place financial hardships on many corporations. No provision is made for forgiveness of part of the tax, as was the case when individuals were placed on a pay-as-you-go basis. By pyramiding income-tax payments for the next 5 years, both medium-sized and large business will be deprived of necessary operating cap-

ital and possibly be forced to borrow funds to meet their tax payments. Congress should carefully reconsider this provision, since it will deter and discourage, rather than promote, business expansion and increased employment.

11. Depreciation.—In order to reduce the number of disputes as to the useful life of capital assets which had reached such a volume as to seriously affect the operations of the Tax Court and the appellate staff of the Internal Revenue Service, the Commissioner, after much consideration, issued mimeograph 183 and circular 144 under date of May 11, 1953, containing a statement of policy, with respect to depreciation adjustments, under which revenue employees shall propose adjustments in the depreciation deduction only where there is a clear and convincing basis for a change. It was stated in the mimeograph that it was to "be applied to give effect to its principal purpose of reducing controversies with respect to depreciation." This policy has done much to accomplish its purpose, considering the short time since its publication.

Section 167 (e) of the Revenue Code of 1954 nullifies this policy by providing that if the useful life of any property, as determined to be appropriate by the Secretary, differs by more than 10 percent from that used by the taxpayer, the Service may propose a change.

A 10-percent margin for difference in opinions with respect to anything as indeterminable as the useful life of property, is so small as to render it entirely ineffective. Useful life of property is affected by obsolescence, maintenance, decisions of management, business conditions, and many other factors; and any determination made of such useful life is at best an informed judgment.

It is therefore strongly recommended that section 167 (e) (1) be deleted, or if not, at least amended by substituting one of the following: (1) "The useful life of any property as used by the taxpayer shall generally not be disturbed and the Secretary or his delegate shall propose adjustments in the depreciation deduction only where there is a clear and convincing basis for a change." This would coincide with the announced policy of the Service as contained in mimeograph 183; or (1) "Unless the useful life of any property, on which the depreciation deduction is based, determined to be appropriate by the Secretary or his delegate, differs substantially from the useful life used by the taxpayer, the depreciation allowable for such property for such taxable year shall be based on the useful life used by the taxpayer." This would coincide with the statement in Internal Revenue Bulletin No. 144; or if it is felt essential to state a definite percentage in the law it should be a reasonable percentage such as: (1) "Unless the useful life of any property on which the rate of depreciation is based, determined to be appropriate by the Secretary or his delegate, differs from the useful life used by the taxpayer by more than 35 percent, the amount of depreciation for such property for such taxable year shall be the amount of depreciation based on the useful life of such property used by the taxpayer."

Construction begun before and completed after December 31, 1953.—Section 167 (c) provides that the use of methods and rates provided for in subsection (b) shall apply only to certain property, the construction, reconstruction and erection of which is completed after December 31, 1953, and then only to that portion properly attributable to construction, reconstruction and erection after December 31, 1953.

Since depreciation normally starts when property is completed and placed in service, it is recommended that this section be amended to correspond to the related provisions of section 168, which provides for the amortization of emergency facilities as follows: Section 167 (c)—Subsection (b) shall apply only in the case of property (other than intangible personal property) described in subsection (a)—(1) the construction, reconstruction, erection or installation of which was completed after December 31, 1953; or (2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

12. Foreign Tax Credits: (A) Applicable to dividends received.—Under the present and proposed code, a domestic corporation which owns the majority of the voting stock of a foreign corporation may not receive a dividend from such foreign corporation in a loss-year without losing the benefit of the Foreign Tax Credit provided for in section 902 (a) of the 1954 code, because any operating loss carryback or carryover would be reduced by the full amount of the dividend received from such foreign corporation.

It is recommended, therefore, that a subsection (a) (4) be added to section 902, to provide that in years in which a net operating loss is realized and in which a dividend is received which would qualify the taxpayer for the credit provided in section 902 (a) (1), (2) and (3), that the tax credit so provided

shall also be a carryback or carryover, as the case may be, to the same year as the operating loss carryback or carryover relates.

(B) *Applicable to branch income.*—Taxpayers sustaining a loss in a year in which they have income from foreign sources on which a foreign tax has been paid, cannot include such foreign tax in its credit for foreign taxes paid. This results in an obvious duplication inasmuch as the income from foreign sources is first subject to the foreign tax, and the remaining balance is again subjected to the United States income tax. From either a tax or foreign trade viewpoint this treatment appears inequitable.

It is believed this oversight in the new law can be corrected by adding the following new subsection to section 955:

Section 955, subsection (3): At the election of the domestic corporation the credit for foreign taxes paid, in computing the tax liability for a year to which an operating loss has been carried, shall include all taxes paid or accrued by such branch with respect to the branch income taken into account in that year.

(C) *Election between "per country" and "overall" limitations.*—The retention in the proposed bill of the "per country" limitation unfairly prevents taxpayers operating in foreign countries with rates both above and below the United States tax rate from averaging these foreign taxes in computing the foreign tax credit to be allowed against the United States tax. The proposed bill removes the "overall" limitation but does not permit averaging of foreign taxes and accordingly is of benefit to only a limited number of taxpayers engaged in foreign trade. The proposed law would also make the credit unavailable or incomplete where different foreign countries impose multiple taxes on income as from sources therein when under our code there is no income, or a lesser amount, from sources within such jurisdictions. In order that the benefit may be on a less restricted basis, it is recommended that taxpayers be allowed to elect annually as to whether the "per country" or "overall" limitation shall apply.

13. Income from foreign sources—(*A*) *Credit for business income from foreign sources.*—The commendable objective in the President's budget message that "Business income from foreign subsidiaries or from segregated foreign branches * * * should be taxed at a rate 14 percentage points lower than the regular corporate rate" is poorly achieved by the proposed bill due to its severely restrictive provisions. The most serious limitation is that which restricts the benefit to earnings derived from conducting a business through a "factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country." Relief would accordingly be denied to all taxpayers not coming within these narrowly defined categories; for example, the mention of only a "retail establishment" is a capricious discrimination against the wholesale establishment which is not mentioned.

As a result of this discrimination, wholesale export operations would receive no benefit, regardless of substantial assets invested abroad, and a manufacturing concern, otherwise eligible for the credit, might fail to qualify because wholesale distribution was combined with production, even though in an integrated operation. If the bill is enacted in its present form, the investor would have to decide whether, contrary to sound business principles, he would dismember his organization in order to obtain the favorable tax rate for a portion of his operations or would instead continue his vertical integration and hope that the credit would apply to the entire earnings of the venture.

The unsatisfactory tests above quoted and discussed should be replaced with the simple test of whether the business is conducted in the foreign country through a "permanent establishment," such term to be defined on the basis of the definitions thereof contained in our tax treaties. The reliability of such a test has been shown by its repeated adoption in a series of treaties running over many years.

(*B*) *Inequitable restriction on purchases outside hemisphere.*—Section 921 of H. R. 8300 replaces section 109 of the existing code with an amendment intended to correct prospectively an inequitable ruling disqualifying otherwise eligible concerns merely because they purchase goods outside the Western Hemisphere. The ruling having been contrary to congressional intent and what had generally been considered the well-established rule, it should be overruled retroactively, and the new matter phrased as a clarifying amendment. This could be accomplished by amending the first line of section 921 as follows: "for purposes of this subtitle and of section 109, Internal Revenue Code of 1939 as amended, the term 'western Hemisphere Trade Corporation' means" etc.

The language indicated by the (above) appears to be the most clear and direct method for accomplishing retroactivity. An alternative method for accomplishing the same result would be to clarify section 7851 (a) (1) (A) by adding at the end thereof the language "except that section 109 of such code is clarified by section 921 of subtitle A of the Internal Revenue Code of 1954."

It should also be noted that the parenthetical phrase in section 921, "(other than incidental purchases)" is ambiguous, since it is not clear whether the word "incidental" should be interpreted according to dollar volume, on a percentage basis, on the basis of frequency, amount, essentiality, or some other basis. In lieu of the above parenthetical insertion whose ambiguities would lead to administrative difficulties and litigation, there should be substituted the language contained in the following recommendation of the American Bar Association: "Our recommendation, therefore, is that the parenthetical clause in section 921, namely, 'other than incidental purchases,' be deleted and that a new sentence be added at the end of section 921 which reads as follows: 'As used in this section, the phrase "all of whose business is done" does not include purchases in a country or countries outside of North, Central, or South America or outside of the West Indies or of Newfoundland, nor does it include non-income-producing activities merely incidental to its business, occurring in such country or countries.' "

If, as a matter of policy, it is decided that H. R. 8300 should contain no retroactive provisions, it is then suggested that clarification in the Senate Finance Committee report may be accomplished by amending the language contained in the report of the Committee on Ways and Means (p. A253) as indicated below.

This section is, in substance, identical with section 109, 1939 code, except that in the interest of added clarity, and to conform with the original intent of the section, it is expressly provided that a domestic corporaion which does all its business in the Western Hemisphere is not disqualified because of (incidental) purchase elsewhere.

14. LIFO.—The Board of Commerce strongly urges that the Senate Finance Committee restore to the tax revision bll H. R. 5295 and H. R. 5296, which permit the lower of Lifo, cost or market, for the determination of inventory value for income-tax purposes. The inclusion of either of these bills in the tax revision bill will remove grave inequity among taxpayers whose taxable income is substantially affected by inventory methods. Many diverse organizations have been urging this revision on Congress. Twenty different organizations have peared before the Ways and Means Committee to urge the inclusion of the lower of LIFO cost or market inventory valuation as a part of the tax revision bill.

Those who testified included the following among this group of 20 organizations: The American Cotton Manufacturers Institute; the American Mining Congress; the American Retail Federation; the National Retail Dry Goods Association; the National Association of Manufacturers; the National Coal Association; and the American Institute of Accountants.

15. General rule for taxable year of deduction—Section 461.—There shall be added to subsection (c) a subsection (c) (2) (A) as follows: (A) "No taxpayer shall be required to change its method of deducting property taxes to the method provided in subsection (1) if it has used another method with approval." Accordingly subsection (c) (2) should be renumbered subsection (c) (2) (B).

16. Reorganization section 359 (b) (2).—It is recommended that section 359 (b) (2) be eliminated entirely. The effect of the section is to discriminate against small corporations. In many instances the only practical way to dispose of a small business is to merge with a large corporation. It appears unreasonable to require that the shareholders of the small corporation acquire any predetermined percentage of the purchasing corporation's stock in order to come within the tax-free exchange provisions of the code.

FEDERAL TAXATION COMMITTEE—DETROIT BOARD OF COMMERCE, 1953–54

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William H. Walter, Detroit Steel Products Co.
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NATIONAL MILK PRODUCERS FEDERATION,
Washington, D. C., April 26, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I desire to submit this brief statement in behalf of the National Milk Producers Federation for the consideration of the Senate Finance Committee in connection with H. R. 8300.

The federation represents some 500,000 dairy farmers and the cooperative associations which they own and operate and through which they act together to market at cost milk and dairy products.

The Revenue Act of 1951 substantially changed the law applicable to the taxation of farmers' cooperatives. As the new law becomes operative, some procedural defects appear which should be corrected.

Although the cooperatives are allowed 8½ months after the close of the taxable year to complete the allocation of net savings to patrons, income-tax returns under the present law must be filed within 2½ months after the close of the year. The Treasury Department has recognized this defect and corrected it on a year-to-year basis by extending the filing time for income-tax returns to correspond with the 8½ months allowed for allocation. Section 6072 (d) of H. R. 8300 would correct this defect on a more permanent basis and should be retained in the bill.

Charitable contributions by corporations would be limited to a percentage of taxable income (H. R. 8300, sec. 170 (b) (2)). One of the incidental effects resulting from the change made by the Revenue Act of 1951 is that farmers' cooperatives are now required to account for charitable contributions. However, if they allocate net savings to patrons in the manner contemplated by that act, they have no taxable income figure to use as a base for computing the percentage limitation on charitable contributions. As a result, charitable contributions by such cooperatives in many cases actually create a tax liability, thus penalizing the making of contributions instead of encouraging them.

We feel sure that this unfortunate incidental effect of the 1951 act was neither foreseen nor intended by Congress. It could be corrected by inserting after the words "taxable income" in section 170 (b) (2) of H. R. 8300 the following: "(in the case of cooperatives taxable under secs. 521, 522, net savings prior to allocation)."

The federation opposes any amendments to the bill which would increase the tax burden of farmers' cooperatives.

Sincerely yours,

E. M. NORTON, *Executive Director.*

CHICAGO, ILL., *March 25, 1954.*

DEAR SENATOR: Please defeat the administration proposal. There is no need to extend the date for individuals to file income-tax returns from March 15, as at present, to April 15, as proposed.

The administration alleges that more complicated cases require additional time so as to minimize pressure on accountants and attorneys. This may be true for more complicated cases. It certainly is not true for the substantial majority of income-tax payers.

Of 245 customers whom I serviced this year, not 2 percent were "more complicated." Yet even these were handled on time because the customers had not waited until the last day but had come with their problems in February. That allowed time enough to make inquiries and secure information needed to process the completion of their reports.

The other 98 percent of my customers are primarily wage earners, with a sprinkling of self-employed or small-business men and landlords living in their own apartment buildings. They do not have more complicated income-tax problems. They need no extension of time. In fact, most of them procrastinate unreasonably.

Approximately half of my customers are repeaters—customers whose work I handled the prior year in this, a transition neighborhood, where I lose old and gain new customers. The excessive procrastination of these old and new customers is indicated by my experience. This year I sent notices to old customers in January; a small number responded; and I service them in January and prior to mid-February. At that time, as in prior years, I opened a temporary office in a nearby store and sent another notice to old customers about February 18. In addition, I placed a large (3- by 5-foot) income-tax service sign in the window of the store. Pedestrians and bus riders stopping at this corner store could not miss seeing these signs.

It was not until March 8, only a week before the deadline, that I was handling as many as 10 customers a day. On March 12 there were 15, and on March 13 and 15 the exhausting numbers of 28 and 38, respectively. These customers could have come weeks earlier. Instead, they procrastinated, as in prior years, until the last 3 days primarily.

There is no justification to extend time for them. Extension will mean that they will procrastinate more. For such customers the present practice of the collector of internal revenue providing extensions of time, when requested, will suffice.

The only possible justification to extend time is to relieve an alleged pressure on accountants and attorneys. However, to determine what their experience is, I phoned a half dozen of the largest accounting firms in the city. Several desire the extension and claim that it will reduce the present pressure on them from January 1 to March 15, but some of these, when questioned, admit that this pressure occurs prior to January 15 and again in March, with an intervening lull. Some admit that, if they circularized their customers earlier in the season, the pressure of the last weeks could be reduced and the work spread throughout the season.

Every firm hesitated; didn't want to estimate the percentage of "more complicated" cases require extensions of time. The number was small. When I suggested 10 percent, the answer was "No." They wouldn't even volunteer 5 percent. The conclusion is that it is possibly several, certainly not 5 percent.

This—and no doubt it is typical throughout the Nation—disclaims any need for a general extension until April 15. Its motivation appears to be for the administration to claim political advantage, with no benefit, but harm, to most taxpayers.

Sincerely yours,

ALBERT BOFMAN.

JONES & LAUGHLIN STEEL CORP.,
Pittsburgh, Pa., April 22, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR MILLIKIN: Legislative bodies and governmental officials are properly taking an ever-increasing interest in the abatement of air and water pollution. Such programs will require huge capital investments on the part of

industry. Such investments will be primarily for the public benefit since in most cases they will return no direct profit to the business.

Under the circumstances it seems fair that an industrial concern which makes an investment to abate air or water pollution should be permitted, if it so desires and if it has adequate earnings, to recover the amount of such investment by amortizing it over a period of 60 months.

I recommend, therefore, that there be included in H. R. 8300, which is now being considered by the Senate Finance Committee, a provision for amortization of the cost of facilities to abate air or water pollution. For this purpose I wish to suggest for your consideration the addition of a new subsection (i) to section 167 of H. R. 8300 which would be worded as follows:

"(i) In the case of property the construction, reconstruction, installation, or acquisition of which is required by the laws of the United States or of any political subdivision thereof for the purpose of preventing or abating the pollution of the atmosphere or of streams, rivers, lakes, and other bodies of water a 'reasonable allowance' for the purposes of subsection (b) of this section may, at the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, be based on a useful life of sixty months beginning with the month following the month in which the property was completed or acquired or with the succeeding taxable year, except that with respect to such property completed or acquired prior to January 1, 1954, such sixty-month period shall begin with the month following the month in which this subsection is enacted or with the first taxable year following such month. An election made by the taxpayer under this subsection may be terminated by the taxpayer at any time."

Sincerely,

BEN MOREELL.

GENERAL FEDERATION OF WOMEN'S CLUBS,
Washington, D. C., April 23, 1954.

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

MY DEAR SIR: The General Federation of Women's Clubs, as you probably know, consists of American women, wives and mothers for most part, and has a membership in the United States of over 5 million.

The General Federation of Women's Clubs has been interested in and has had resolutions since 1944 urging that all people under similar circumstances have equal protections as well as equal responsibilities.

It seems to us under the existing laws this is not true for some persons who qualify as taxpayers under the present code.

Therefore, the General Federation of Women's Clubs would like to throw its support to the Kerr amendment to section 214 of H. R. 8300 which would, as we see it, not only exempt taxpayers, both married and single, caring for children that are not their own but would also include taxpayers having care of infirm and incompetent dependents. Further, this amendment, as we see it, is a right-to-work amendment.

Due to the fact that a business engagement takes me out of Washington for the next 10 days, it will be impossible for me to appear in person to make a statement for this organization; therefore, I hope this letter will be incorporated in the testimony.

Sincerely,

SALLY BUTLER,
Director, Legislative Research.

SAN FRANCISCO 4, *April 23, 1954.*

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

DEAR SENATOR MILLIKIN: Since obtaining prints of H. R. 8300 and the report of the Committee on Ways and Means on the bill, I have given as much time as I could to study of the bill, and as the result of this study have found a number of points with regard to which I feel that question may fairly be raised

and which should be further considered in the process of enactment of the bill. Time has not sufficed for an exhaustive examination of this tremendous bill. Any criticisms offered are made in a constructive spirit. The draftsmen of the bill are entitled to great credit for the job they have done. There is so much which is good in the bill that I hope it will be enacted into law at this session, but I respectfully suggest that it would be wise and fair procedure to defer the coming into effect of certain portions of the bill (mentioned specifically hereinafter) until 1955, in order to give interested organizations and counsel for taxpayers an opportunity for adequate analysis of their complex provisions and their ramifications and implications. Many helpful suggestions for constructive amendments will come out of this deferment of effective date which Congress and its technical advisers can consider early next year, but this will not involve indefinite delay in acting upon the bill as a whole.

It is my personal view that the early enactment of such provisions of the bill as those relating to depreciation, deductibility of expenditures for research and development and for grading, conservation, drainage, etc., of agricultural lands, revision of the law now contained in section 102 of the code and the provisions governing definition of and carryback and carryover of net operating losses, as well as the new dividend exclusion and credit allowance to give some measure of relief from double taxation of corporate profits, is vitally important to the preservation and promotion of our dynamic economy upon which the welfare of all depends. Action upon such essential matters should not be deferred until the technical intricacies of such subchapters or sections of the bill as those relating to corporation reorganizations, exchanges and distributions, partnerships, and discharge of indebtedness can be solved to the general satisfaction. It is safe to say these latter will never be solved so as to satisfy everyone.

In connection with the new provisions lightening somewhat the heavy tax burden borne by corporate profits distributed as dividends, it should be noted that their enactment would provide a healthy stimulus to investment of equity capital in corporate expansion, beneficial in point of increased employment and enhancement of the general standard of living. Also, a change in the tax law which will help corporations to finance their capital needs to a materially greater extent by the sale of equity stocks in lieu of debt securities will increase corporate income-tax collections by reducing corporate interest deductions. Critics of the foregoing changes not only largely ignore the foregoing considerations but also forget that, until the enactment of the ill-fated and short-lived corporate undistributed profits tax in 1936, it had been settled policy to allow individuals receiving dividends a credit therefor against normal tax. For no apparent reason other than the increasing pressure for revenue, neither was this credit revived nor an allowance in lieu thereof made after the undistributed-profits tax was repealed.

The criticisms and suggestions which follow relate to specified portions of the bill.

Section 76 of the bill, relating to discharge of indebtedness, when read with the committee report, appears to fall far short of its professed purpose of substituting definiteness and certainty for the confusion which has enshrouded this matter. The section seems to me inferior in these respects to the American Law Institute's proposed solution. Particularly unfortunate are the facts that the controversy which gave rise to the *American Dental Co.* decision (318 U. S. 322), on the one hand, and *Commissioner* v. *Jacobson* (336 U. S. 28), on the other, is probably reopened, and that the section, by failing to codify the insolvency limitations reflected in such cases as *Lakeland Grocery Co.* (36 BTA 289), will force insolvent taxpayers to go into bankruptcy in order to wipe out their indebtedness without tax liability, instead of resorting, as many would prefer to do for quite proper reasons, to private creditors' compositions through the good offices of boards of trade and otherwise. It is respectfully submitted that it carries theory to unsound extremes to leave any harassed debtor, who has settled with his creditors outside a bankruptcy court by surrendering to them all or the great bulk of his assets, saddled, after he has done this, with income-tax liability exceeding the value of such property as he may have been permitted to retain. The memorandum attached hereto develops further the foregoing as well as other criticisms of this section and the related provisions of sections 108 and 1017. It is believed that the sections require extensive redrafting. If time does not permit this to be done now, they should not be enacted without deferring their effective date for at least a year.

Section 165 (c), relating to theft losses (which presumably includes embezzlement as under present law), if accepted in its present form, would enact into law a rigid rule that "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." Under the present law the Commissioner had sought to enforce a different but equally rigid rule based upon his interpretation of the literal language of the statute under which such losses could be deducted only in the year or years in which the acts of theft or embezzlement occurred. In many cases, this rigid rule operated to deny any deduction whatever since the statute of limitations had run before the defalcation was discovered by the taxpayer. The courts in certain hard cases of this sort refused to sustain the Commissioner's position, and allowed the deduction to be claimed in the year of discovery or the year when any reasonable possibility of recovery from the known thief or embezzler vanished. In *Alison* v. *United States* (334 U. S. 167, 73 S. Ct. 191), the Supreme court repudiated the Commissioner's rigid rule and on the facts presented allowed deduction of losses due to embezzlement in the year of discovery, but the Supreme Court carefully refrained from laying down a rigid rule, such as section 165 (c) of the bill would do.

The desire for certainty and minimizing of litigation in this field, which undoubtedly motivates this provision, is appreciated and is deserving of sympathy. Nevertheless, it is submitted that at least one exception to its rigid rule must be written into it if new and intolerable injustice is to be avoided in one class of cases. The cases in question involve situations in which the amounts stolen or embezzled are includible in the gross income of the victimized employer or principal who is the taxpayer but have not been reported by him due to the fraud or concealment of the thief. Such situations are particularly likely to occur in the case of small businesses which have relatively simple or primitive accounting systems, the operation of which is left to a trusted employee. Such employee may intercept income payments and convert them to his own use and at the same time make sure they do not get onto his employer's books from which the income-tax returns are prepared. The employer is not properly chargeable with penalties for fraud in such cases but nevertheless there is a deficiency in his income-tax liability, unless he is allowed to offset the understatement of his income by a deduction for theft or embezzlement loss. But under section 165 (c) the loss is arbitrarily thrown into some later year when the taxpayer's income situation may be much less favorable, except in the unusual case where he is fortunate enough to discover his employee's dishonesty in the same year in which the peculations first occurred. And there has never been any problem in such a case, even under the Commissioner's rigid rule. In order to avoid substituting one set of injustices for another, section 165 (c) should be amended so as to permit the deduction in such cases in the same year or years in which the amounts stolen or embezzled are required to be reported in the gross income of the principal.

The next matter is one which is not dealt with by the present bill, an unfortunate omission, in our judgment. It involves a situation of unjustifiable double taxation of the same income, which has arisen out of judicial decisions. On the one hand is the case of *William F. Davis, Jr.*, v. *Commissioner* (17 T. C. 549). In this case the Tax Court held that where the Securities and Exchange Commission determined that the petitioner, who was an officer and director of the corporation in whose stock he was dealing, had violated section 16 (b) of the Securities Act by such dealing and where the petitioner had thereafter pursuant to the requirements of such act, paid over to the corporation the gain realized therefrom, said petitioner was not entitled to deduct such payment to the corporation on the ground that the sanction imposed by section 16 (b) is in the nature of a penalty and that the allowance of a deduction therefor would mitigate the deterrent effect thereof and so subvert a sharply defined public policy. While this result was reached over the strong dissent of six judges of the court, it has presumably established the position of the court. The result in the case was the same as would have been reached had Congress made the violation of section 16 (b) punishable as a crime, something Congress deliberately refrained from doing. Despite this decision, the Tax Court held in a later case involving section 16 (b) that the receipt by the corporation of an amount representing profit realized by a corporate officer on dealing in its stock constituted income to the corporation. See *General American Investors, Inc.* (19 T. C. 581). This decision has recently been affirmed by the United States Court of Appeals for the Second Circuit, and is in accord with the decision of the Court of Claims

in *Park & Tilford Distillers Corp.* v. *United States* (107 F. Supp. 941, cert den. 345 U. S. 917). There seems to be no justification for the savage overall result flowing from these cases, particularly since the application of section 16 (b) does not turn upon the presence of fraudulent or evil intent. We do not quarrel with the later cases which tax the payment to the corporation, even though they are difficult to reconcile with the criteria of taxable income set forth in *Eisner* v. *Macomber* and other earlier cases. But, if these decisions are permitted to stand, it is respectfully submitted that the Davis case in the Tax Court and its rationale should be abrogated by legislation.

There are so many questions both of policy and draftsmanship presented by subchapter C relating to corporate distributions and adjustments as to raise a very serious question of the wisdom and propriety of enacting these provisions into law which will become effective at a date or dates in 1954 antedating by several months the actual date of enactment of the bill. I agree in general with the point of view towards this subchapter and subchapter K relating to partnerships expressed by Mr. Thomas Tarleau in his appearance and testimony on behalf of the council of the section of taxation of the American Bar Association. It is my earnest belief that the public interest would be served if subchapters C and K should be enacted, with such improvements as may be possible this year in the limited time available, but with their effective date postponed until some time in 1955, giving opportunity for concentrated study of their provisions in the meantime and further perfecting amendments by the Congress early next year. The other alternative would be to postpone action upon the content of these subchapters for another year. These subchapters have vital and far-reaching effects upon the conduct of business. Premature and insufficiently considered action by Congress may have very harmful effects, contrary to the general purposes of the code revision to promote the welfare of the economy and minimize tax uncertainties in connection with business transactions.

Attention is called in the following paragraphs to a few of the more serious questions which have arisen in my mind in the course of my examination of the complex provisions of subchapter C.

Section 305 (c) (1) of the bill would treat as a distribution in lieu of money and therefore taxable a distribution made "in discharge of preference dividends on nonparticipating stock currently owing or in arrears." Presumably such a distribution to the extent not in excess of corporate earnings and profits would be taxable to the recipients as ordinary income. The committee report does not specifically state whether this provision is intended to abrogate for the future the rule of the leading case of *Skenandoa Rayon Corp.* v. *Commissioner* ((CA 2) 122 F. 2d 268, cert. den. 314 U. S. 696), which treated the right to undeclared accumulated dividends on cumulative preferred stock as a security within the meaning of the tax-free exchange provisions in recapitalizations and other reorganizations. We seriously question the wisdom of the policy of abandoning the prior rule, if such be the intention, in those cases where the dividend arrearages are treated in the reorganization as one of the integrated body of rights constituting ownership of the stock. To do so would create a serious clog upon the reorganization of corporate enterprises whose recourse to the capital market may be seriously impeded by arrearages in cumulative preferred dividends. The bill also fails to supply a clear answer, where the preferred stockholders receive only stock in exchange, to the question of how such stock is to be allocated between the old stock and dividends accumulated thereon. For all that appears in the bill, some portion of the stock received will be taxable as ordinary income. Finally, the unfairness of taxing any amount so allocated to dividends is accentuated by the failure of part I of subchapter Q of the bill, sections 1301 et sequa, to apply the technique of attributing to several years income received in a single year to case where preferred dividends accumulated over several years or bond interest delinquent for several years are paid in a single year, resulting in an abnormal concentration of income in a single year and a disproportionately high tax by virtue of the steep graduation of income surtaxes.

Under section 309 imposing a virtually confiscatory (85 percent) excise tax on certain transfers of nonparticipating stock regarded as involving the form of tax avoidance commonly called preferred stock bailout, and section 391 (a) relating to the effective date of subchapter C, a most unjust result will be produced in certain cases which we do not believe Congress can understand and deliberately intend. Section 309 (c) provides that, for the purpose of the section, "nonparticipating stock shall be deemed issued on the date of issuance of such stock or January 1, 1954, whichever is later." Under section 391 (a) (2), the tax imposed

by section 309 applies to amounts distributed after the date of enactment of this act. Let us assume a case in which preferred stock was issued as a dividend on common stock, with only common outstanding, in some year prior to 1954 but after 1944. Such distribution was a nontaxable stock dividend under the prior decisions of the United States Supreme Court and the recent decisions of the United States courts of appeal in such cases as the Chamberlin and Schmitt cases, despite the fact that the elements of a so-called bailout may be present. Nevertheless, the stock issued is legally valid and contractual provisions contained in it are binding on the corporation. The dividend stock may to a considerable extent have been sold and passed into different ownership since the date of distribution. Let it be further assumed—not an improbable assumption—that the stock so issued contains provisions requiring its redemption within a period of less than 10 years or, more probably, for annual partial redemptions over a period of years under the operation of a sinking fund required to be established. Under the present bill, as we read it, any distributions in redemption of such stock made after the date of enactment of this bill, if made within the 10 years beginning January 1, 1954, would subject the corporation to an excise tax of 85 percent of the amount thereof, unless one or the other of the exceptions in section 309 applies, even though such distribution is made pursuant to a valid and lawful contractual obligation incurred prior to January 1, or March 1, 1954. Even if the case be one which would clearly be a bailout under the new rules spelled out by section 309, and those rules be conceded to be fair and proper as regards prospective application, the potential results pointed out above represent retroactivity in a glaring and arbitrary form, which we cannot believe Congress would consciously tolerate.

The application of part III of subchapter C, relating to corporate organizations, acquisitions, and separations, and the requirements and conditions imposed in order for the transactions involved to qualify as tax free vary sharply according to whether the corporations involved are so-called publicly held or so-called closely held corporations. This introduces a new concept into this field of tax law which may have far-reaching effects. Consequently, the statutory definition of a publicly held corporation is vitally important. This definition is found in section 359 (a) and states that a corporation will be deemed to be publicly held unless 10 or fewer shareholders own more than 50 percent either of the total combined voting power or of the total value of all classes of stock of the corporation. However, for the purposes of this subsection the ownership shall be determined in accordance with section 311 (relating to attribution of ownership).

No presumptions of status have been found in the bill. Consequently, if the administrative authorities determine that a given corporation, no matter how large the number of its shareholders and regardless of the fact that its securities are listed on one or more public exchanges, is not a publicly held corporation, the burden is cast upon the taxpayers to prove the contrary. And that burden may prove a staggering one to carry when the provisions of section 311 are applied. Hitherto, the concept of attributed or constructive ownership has been limited to the domestic and foreign personal company sections (and even there the vital number is 5 or less shareholders as compared with 10 or less here) and to the situations covered by section 24 (b) of the present code relating to disallowance of losses on sales or exchanges between persons standing in certain relationships. In the new context, however, the concept has vastly broader potential application. A corporation may conceivably have a very large number of shareholders and still fall into the closely held category under the criterion prescribed, after applying section 311, since any stockholder may be treated as owning the shares of any other stockholder standing within several degrees of blood relationship or even in a partnership relation and vice versa. How can any corporation be certain, or how can their counsel safely advise them without an exhaustive and costly survey of the genealogy and business relationships of at least the large bulk of the shareholders?

We suggest that the least that can be done to prevent these difficulties of administration of section 311 from seriously impairing the workability of the new provisions is to create two presumptions: One, that any corporation whose shares are listed on a recognized exchange is a publicly held corporation, and two, a like presumption where the ownership of the stock of a corporation is distributed according to its stock records among a reasonably substantial number of shareholders, with a minimum of perhaps 100. We also think there would be little danger practically if all corporations whose shares are listed on exchanges were deemed conclusively to be publicly held.

As Chairman Reed of the Ways and Means Committee has recognized, according to the press, the effective date provisions of section 391 should also be revised to make it clear that the old law applies to any liquidation or reorganization consummated according to a plan legally adopted in accordance with applicable State law prior to the selected cutoff date, whether by resolution of a board of directors, filing of a statutory consent by the requisite majority of shareholders, or other lawful procedure.

Respectfully,

ARTHUR H. KENT
(For Kent and Brookes).

MEMORANDUM ON SECTIONS 76, 108, AND 1017 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954: DISCHARGE OF INDEBTEDNESS

The basic approach of the new bill, as expressed in section 76 (a), is to consider as income all discharges of indebtedness, except certain specified transactions enumerated in the subparagraphs which follow this general rule. Nowhere, however, does the statute define what is included as an indebtedness to qualify under this section. This omission will clearly give rise to problems of construction in such cases as the cancellation of a surety bond, the settlement of a tort judgment, etc., in which the cancellation can scarcely be intended to give rise to income.

Exception number one to this general rule is expressed in section 76 (a) (1) as being a discharge "effected by virtue of a payment in money." Suppose the discharge of a $100 debt is obtained by the payment of $50 and a peppercorn. Since the discharge was effected by virtue of the $50, would not this exception apply to make the transaction nontaxable? Surely this is the classic case of taxability, in which all of the excess of the face amount discharged over the consideration received ought to be included in income. This exception, unless it is quickly and authoritatively construed by the courts to reach such excess, will therefore create an easily realized method of circumventing the statute.

The second exception is intended to exempt gifts. However, no definition of gifts is supplied in the statute, a situation which gives rise to the *American Dental Co.* (318 U. S. 322) *Commissioner* v. *Jacobson* (336 U. S. 28), controversy. In the absence of the House committee report, we might assume that Congress intended to adopt the Jacobson decision of what constitutes a nontaxable discharge by way of gift. Unfortunately, however, the House report, page 13, indicates that this exception is intended to revive American Dental, since the report states that it covers not only a gift between related persons but also a case in which a creditor "settles a debt for less than full value to assure continued business relations with the debtor." Apart from the merits of this policy, if Congress intends to enact American Dental into the code, it ought to say so; to leave the matter to inference and to reference is to invite protracted litigation between taxpayers and the Commissioner which well may result in a third Supreme Coure pronouncement on this relatively small issue.

The third exception, dealing with capital contributions, wisely eliminates the requirement of the present regulations that the cancellation be gratuitous. However, the additional clause, "whether or not the creditor has any proprietary interest in the taxpayer," seems to us to be so broad as to be meaningless. In any business situation, a discharge could be termed a "contribution" to the debtor's capital. Any regulations framed under this exception will undoubtedly be subjected to extensive litigation. Furthermore, when section 76 is read with sections 108 and 1017, it appears that the forgiveness of a corporation of a debt owed by its shareholder may no longer require the shareholder to reduce his basis for his stock. Section 76 (a) (3) speaks in terms of an exception to the general rules under which gross income results when a discharge is made. Sections 108 and 1017 give the taxpayer the option of returning such gross income as taxable in the year in which it is realized or of reducing the basis of his property by an equivalent amount. Since this alternative treatment is specified only as to income excluded under section 108, any similar income excluded under section 76 (a) would not appear to require an adjustment to basis.

Section 76 (a) (4) has a laudable objective, but there seems to be little to commend its restriction to an adjustment of the purchase price within 12 months after acquisition. Artificial rules for taxing business transactions both result in forcing all of these transactions to fit into a form stereotyped by tax sanctions and become a snare for the unwary.

Section 76 (a) (5) is so broad as to be meaningless. Suppose an employee forgives his employer back wages because he wants to keep his job; no income?

Suppose a debtor is a good business client and his creditor doesn't want to press him; if he forgives the debt, no income? It would be a very unimaginative taxpayer would would not be able to erect a defense on these subsections to any deficiency proposed by the Commissioner which rests upon cancellation of indebtedness.

We note also that the insolvency rules, as expressed by such cases as *Lakeland Grocery Co.* ((1937) 36 BTA 289), are not incorporated into the code; therefore, it appears that only bankruptcy matters will be protected from the sweep of section 76. Other creditors' compositions and arrangements, whether by voluntary agreement or under the auspices of State law, will run the risk of so saddling their debtor with income that all of his assets will be subject to levy by the district director for these taxes upon this income before any amount is paid to the creditors themselves. The importance of this discrimination against voluntary plans to creditors' associations, boards of trade, and similar organizations is apparent. Practically, this omission will have the probable results of causing debtors to be less cooperative in reaching settlements with their creditors and of compelling those who are forced to the wall to select bankruptcy as the preferred procedure for extinguishing their liabilities.

WASHINGTON, D. C., *April 26, 1954.*

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: Pursuant to your invitation contained in your telegram of April 21, 1954, I respectfully submit the following in connection with your hearings on the new revenue law:

I am a lawyer with accounting experience and have been engaged in Federal tax work for 35 years. I have lectured on the subject of taxation for the American Bar Association, the Practicing Law Institute, the American Law Institute, and various universities. I have written several books on tax practice, one of them for the American Bar Association Practicing Law Institute. I do not appear before you representing anyone except myself, and I appear without ulterior motive, solely in discharge of what I deem to be my public duty. In this regard I think I differ from almost all your witnesses, for most of them have axes to grind; and it is sometimes doubtful as to whether they are grinding in the public interest or in the interest of their clients.

I am advocating two reforms, although many are needed. There is no use for me to try to cover such a large field. I realize, too, that nothing is less popular than a suggestion of a general improvement in the public interest.

(1) Something should be done to eliminate influence peddling and other improper devices in tax settlements.

(2) The proposed changes in the law governing pension, profit-sharing, and stock-bonus plans should be reconsidered with a view to working greater equity among all the workers from the lowest to the highest.

I. INFLUENCE SETTLEMENTS

For reasons that it is hard to understand, there has been, over the past few years, a general wearing out or tearing of the moral fiber. The tax-collecting service of the United States, which from the beginning had been singularly free from corruption, sustained its share of the moral collapse. It is not necessary to elaborate on this matter, for the facts are well known now. Perhaps the least said about them the better, for every investigation has had to be stopped before it was completed because of the important people who became involved.

Influence settlements can be cured easily, and it is the cure that I am suggesting.

If the present law dealt fearlessly with them, all that need be done would be the following:

(*a*) Every person who appeared before any Government official in regard to a tax case (whether he appeared in the Government office, a nightclub, a social gathering, or a ball game or racetrack) should be required to present a power of attorney recorded with the Treasury Department and stating, among other things, how he came to represent this taxpayer (including how he met him and the conditions under which he met him) and the amount of his fee. All of this should be under oath and subject to the rules of perjury.

(*b*) Every public official, including Representatives and Senators and including their families, their in-laws, and their secretaries, should be required, upon approaching any person in the Federal taxing service in connection with any tax matter, to state under oath how they met the interested party, why they interested themselves in the case, the amount of the fee they expect to get out of it (whether paid to them directly or to a nominee), and that, in the cases of elective officeholders and their staffs, the interested parties are constituents. All of this should be under oath, subject to the rules of perjury.

II. PENSIONS, PROFIT SHARING, STOCK BONUSES

A review should be made of the proposed legislation to see whether it has not now been rearranged so that only proprietors (stockholders, etc.) and those whom they favor can realize the benefits.

It is respectfully suggested that the present law, while containing some flaws, is better than the proposed one.

It is respectfully suggested that it is grossly unfair to the great mass of working people to allow pensions and other benefits to start only after wages of $3,600 or $4,000 have been earned.

It is respectfully suggested that the 30 percent rule, which is a good one, is really vitiated by the far too liberal provisions that follow it. On the whole, it is my opinion—and I hope you do not mind my saying so—that the new law governing pension, profit-sharing, and stock-bonus plans is strictly a management law.

Please do not misunderstand me; I am at heart a capitalist. I am a part of management. Still, I think that pension, profit-sharing, and stock-bonus plans ought to be for everybody. It is no use to say that there shall be no discrimination and then to provide that benefits start after $4,000, for that provision is gross discrimination against everybody earning under $6,000.

Respectfully submitted.

HOWE P. COCHRAN.

CHAMBER OF COMMERCE,
Johnson City, Tenn., April 20, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SIR: The national affairs committee of the Johnson City Chamber of Commerce respectfully calls to your attention a patent inequity in the proposed Internal Revenue Code of 1954, passed by the House of Representatives as H. R. 8300.

Section 461 of the proposed code is a step in the right direction in permitting the requirement for deducting real-property taxes over the period covered thereby rather than in the month the assessment becomes a charge against the property. However, special rules added by section 461 (c) (2), unless revised, create a new and serious inequity for practically every accrual-basis taxpayer having a fiscal year ending during 1955 (except those on a calendar-year basis).

Under section 461 (c) (2) an accrual-basis taxpayer reporting for fiscal year 1955 in a State where the assessment of property tax becomes a charge against the property during January would be penalized for 1955 by payment of additional income tax on the loss of a proportionate part of his real-property taxes as follows:

Fiscal year ended—	*Loss equals tax on—*
Jan. 31, 1955	11/12 of realty tax.
Feb. 28, 1955	10/12 of realty tax.
Mar. 31, 1955	9/12 of realty tax.
June 30, 1955	6/12 of realty tax.
Sept. 30, 1955	3/12 of realty tax.

The difficulty arises from the fact that, in the swing over to a proration basis, the House became overzealous in blocking the double deduction of property tax. No loss to the Treasury would result from permitting this partial double deduction in the year of change, and a serious inequity will result if it is not allowed. No taxpayer should be denied deduction for a full year's taxes against a full year's income.

To illustrate, a corporation having a $25,000 profit after paying $6,000 real-estate tax would pay—

	Profit		Income tax
	Actual	Taxable	
If fiscal year ends:			
Dec. 31, 1955	$25,000	$25,000	$7,500
Sept. 30, 1955	25,000	26,500	8,280
June 30, 1955	25,000	28,000	9,060
Mar. 31, 1955	25,000	29,500	9,840
Feb. 28, 1955	25,000	30,000	10,100
Jan. 31, 1955	25,000	30,500	10,360
Dec. 31, 1954	25,000	25,000	7,500
Penalty on Jan. 31, 1955, fiscal year			2,860
Percentage of penalty			38

In no case should one corporation pay 38 percent more tax than another under conditions identical in every way except for the difference in the fiscal-year date.

Our area has many taxpayers with fiscal-year closings. Historically, a majority of retail and department stores close January 31, and the burden there would be particularly heavy. Our chamber of commerce solicits your cooperation in amending section 461 to correct this potential injustice.

Respectfully,

ALLEN HARRIS, Jr.,
Chairman, National Affairs Committee.

NATIONAL RETAIL FURNITURE ASSOCIATION,
Washington, D. C., April 26, 1954.

Re hearings on H. R. 8300, conducted by Senate Finance Committee.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C

DEAR SENATOR MILLIKIN: We respectfully request that the views expressed herein be considered by the Senate Finance Committee and incorporated in the printed record of the committee hearings.

The provisions of section 453 (d) of the bill under consideration, which require a corporation to report as income for the year of liquidation the uncollected income represented by installment obligations distributed in liquidation, are in conflict with the theory and apparent legislative intent of the corporate liquidation provisions of section 331, 336, etc.

The purpose of presenting this subject to you is not to attempt to correct an existing inequity, but rather to extend the general intent of the new code to facilitate liquidations of relatively small corporations, to extend the principle in present section 112 (b) (7), and to enlarge it.

There are a great many small corporations that have been reporting on the installment basis for many years who perhaps would wish to avail themselves of the opportunity present in the new code to liquidate such corporations and adopt a single proprietorship or partnership form of enterprise.

The requirement that the liquidating corporation return as income the excess of the fair market value of its installment obligations over its cost basis, in almost all cases, will prove to be a practical barrier to such small corporations because of the amount of the income-tax payment that will be necessary at the time of liquidation.

The consideration of this problem should be made in the light of practical situations rather than theoretical inequities.

We propose that subparagraph (d) (1), section 453, be amended as follows: After the words "relating to the nonrecognition of gain or loss as a result of foreclosure", add "; nor shall it apply to distributions in liquidation as defined in section 336, wherein section 308 (a) and (d) shall apply."

This amendment will enable small corporate taxpayers reporting on the installment basis to avail themselves of the opportunity that apparently is intended in the new code to convert from a corporate form of doing business to a proprietor-

ship or partnership form without an undue income-tax hardship which practically forestalls the availability of this relief to them.

We know of no corporation of the kind that we are referring to here that is in a financial position to discharge the income-tax liability on the unrealized profit in the event of a liquidation of this nature. In fact, we are reasonably sure that there are very few such corporations that are in a sufficiently strong financial position to justify a bank credit or loan to pay such a tax.

We urge that the proposal submitted herein be adopted by the Senate Finance Committee in order to achieve equity for the large class of taxpayers affected by the provisions in question.

Respectfully submitted.

WILLIAM H. ATKINSON,
Chairman, NRFA Tax Committee.

COLONIAL MACHINERY & REBUILDERS, INC.,
Worcester, Mass., April 23, 1954.

MRS. ELIZABETH SPRINGER,
Chief Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR MISS SPRINGER: This company is engaged in the business of dealing in new, used, and rebuilt machinery, maintaining its principal office in Worcester, Mass. We are also engaged in the rebuilding of used machinery.

Our attention has been directed to the 1954 Internal Revenue Code, House bill 8300, specifically with respect to section 167, having to do with depreciation.

It appears that depreciation allowances are to be afforded only with respect to new machinery and will not be afforded to used and rebuilt machinery. This, in our opinion, seems eminently unfair, not only from the point of view of the used-machinery industry, which will be tremendously handicapped in the sale of its used and rebuilt machinery, but will also be tremendously unfair and inequitable to the users, more particularly to the several thousands of small machine shops throughout the country which are not in a position financially to afford a capital outlay for new machinery, but which are dependent upon rebuilt and used machinery for maintaining and operating their respective plants.

We have had reactions from many of our small customers who are manufacturers and who seem to feel that this is a preferential treatment, and, with business conditions as they presently are, such preferential treatment they feel should be afforded to the smaller businessman by way of giving him an opportunity to buy used and rebuilt machinery in view of the fact that he cannot afford to pay top prices for new machinery, and that he be afforded the advantage, under the present depressed economic conditions in this particular industry, of a helpful depreciation such as is afforded to, or attempted to be afforded to, the new machinery builder.

We, as do many other owners of businesses similar to ours, feel that the market will be tremendously depressed by the enactment of this legislation without equality being afforded with respect to used and rebuilt machinery.

Under the circumstances, and with us bending our efforts to help maintain the present economic conditions of our country, we urge you to make the depreciation allowance applicable to used and rebuilt machinery, since it is our feeling that it will be extremely helpful in staving off the fears of economic depression which is now being talked about so much here and throughout the country.

Respectfully yours,

FREDERICK BABBITT,
General Manager.

HARRIS P. DAWSON, M. D., F. A. A. P.,
Montgomery, Ala., April 16, 1954.

HON. JOHN SPARKMAN,
United States Senate,
Senate Office Building,
Washington, D. C.

DEAR MR. SPARKMAN: We are interested in dissolving our family corporation, but are prevented from doing so because of the high income tax when the property of the corporation is transferred to my two sisters and myself.

The property has considerably increased in value since the corporation was formed some 28 years ago.

If it were possible to dissolve the corporation and distribute the assets under the provisions of section 112 (b) (7), this would save us considerable money, but this section is no longer in effect since the liquidation has to take place in the year 1951 or 1952.

I am informed there is a new revenue bill before Congress at the present. Would it be possible to amend the Revenue Act on the floor by striking out the words "1951 or 1952" and inserting in lieu thereof "1954 and 1955"? Similar amendments have previously been made to the act to extend the time so that stockholders might take advantage of this section.

We could not take advantage of the old act due to the fact that we were engaged in litigation and the corporation could not be dissolved. I would appreciate your efforts in having the Revenue Act amended so as to extend the time for dissolving a corporation under the benefits of section 112 (b) (7) at least until 1954.

With kindest regards and best wishes, I am

Yours very truly,

JENNIE B. DAWSON.

STATEMENT OF ROBERT H. CAFFEE IN BEHALF OF THE SMALLER MANUFACTURERS COUNCIL OF PITTSBURGH

The members of the Smaller Manufacturers' Council of Pittsburgh, Pa., appreciate the magnitude of the task undertaken by the House Committee on Ways and Means, but want to make the point that H. R. 8300 falls woefully short of accomplishing its objective in respect of small businesses.

In his budget message to the Congress on January 21, 1954, President Eisenhower said:

"In addition to the tax treatment of depreciation which is important for all business, there are other features of the tax law which are of special importance to small business."

Many of us in the small business community looked upon this as a promise of better treatment for small businesses. But the promise has not been fulfilled. In fact the measures which discriminate against small business outweight the benefits to an extent that makes the present law considerably more desirable than H. R. 8300.

May I recount some of the provisions which have been enacted into the law, and which we feel place the small-business man in a position of being unable to grow in an age of growth; unable to expand at a time when the economy needs the expansion of all businesses, and the start of new small businesses.

1. Redemption of stock.

Present law provides that a partial redemption of stock on a pro rata basis be taxed as a dividend. However, what is a pro rata basis has never been clear, and has been the subject of much litigation. Section 302 of H. R. 8300 clarifies this by determining that a redemption is not pro rata (therefore not taxable as a dividend) if it reduces the stockholder's proportionate interest in the company below 80 percent of his previous interest.

This hurts small corporations on two counts:

(*a*) Frequently, closely held corporations have to rely on one of the stockholders buying preferred stock to get financing for the corporation. Assume that a corporation with 100 shares equally owned by A and B agrees to redeem some of B's shares. To get below 80 percent of his relative interest B has to sell 17, or more than one-third of the shares he owns. If A owned 10 shares, and B 90, B would have to redeem 65 of his 90 or have the transaction taxed as a dividend.

Large or publicly held corporations are not adversely affected because they can borrow the additional financing, or can sell preferred stock to the public.

(*b*) The stockholdings are usually substantial, which may require a very substantial redemption in order to reduce his relative interest. For example, a corporation with 100 shares equally owned by A and B, agrees to redeem some of B's shares. To get below 80 percent of his relative interest B has to sell 17, or more than one-third of the shares he owns. If A owned 10 shares, and B 90, B would have to redeem 65 of his 90 to have the transaction taxed as a dividend.

2. Loss carryovers

Section 382 of H. R .8300 provides that where a stockholder's stock ownership has increased by 50 percent or more during the taxable year, any net operating loss carryover from a prior year will be reduced accordingly, if the corporation is not a publicly held corporation. This applies whether the stockholder's increased percentage holding is the result of his purchase of additional stock or redemption by the corporation of other stock which automatically increases his percentage.

3. Depreciation

This is one of which President Eisenhower hoped for so much in his budget message. The President said:

"I recommend that the tax treatment of depreciation be substantially changed to reduce these restrictions on new investment, which provides a basis for economic growth, increased production, and improved standards of living. It will help the manufacturer in buying new machinery and the storekeeper in expanding and modernizing his establishment. It will help the farmer get new equipment. All of this means many more jobs.

"Specifically, I recommend that business be allowed more freedom in using straight-line depreciation and in selecting other methods of depreciation."

Let us examine how far section 167 of H. R. 8300 fails to go in carrying out this blueprint, this hope for small businesses. The declining balance method at 200 percent of the straight-line rate can be helpful to even small business, but the restrictions against small business more than offset the advantages. For example:

(*a*) The new declining balance rate is applicable only to new equipment, and is usable only by the first purchaser of such equipment. Most small businesses start with secondhand equipment, and work up to new equipment. This defect hurts all business, because while the new rate may encourage the buying of new equipment, it could also dry up the market for the used equipment that is being replaced.

(*b*) Section 167 virtually precludes the use of any method of depreciating new equipment other than the declining balance method, because subsection (b) (3) does not permit the use of any alternative method under which the accumulated allowance in a given year exceeds the allowance that could have been taken under the declining balance method. Of course, any method which permits ultimate 100 percent depreciation must at some time exceed the accumulation under the declining balance method because that never gets to 100 percent.

(*c*) The concept of depreciation and the measure of the rate (whether declining balance or straight-line) are still based on Internal Revenue's Bulletin F, which we consider an obstruction to expansion. Bulletin F is based on averages on "useful life" determined in the 1930's, and taking into account no technological changes since then. Moreover, Bulletin F imposes a policy of "useful life" without regard to replacement cost.

In connection with bulletin F, we would recommend that section 167 (e) of H. R. 8300 be amended specifically to provide that any difference between the useful life concepts of the Treasury and the taxpayer be determined without reference to bulletin F. We also feel that instead of 10 percent, the margin of variation should be 25 percent.

4. Statutory mergers and consolidations

Under present law statutory mergers have no tax effects, and this is true of section 354 of H. R. 8300, provided both corporations that are parties to the merger are publicly held. If one or both of them is closely held the merger is a taxable transaction unless the limitations of section 359 apply. Section 359 provides that unless the transferor and transferee were owned by the same interests or after the consolidation the shareholders of the transferor own at least 25 percent and not more than 400 percent of the stock of the transferee owned by the original stockholders, the transaction will be taxed as a sale rather than as a tax-free merger or consolidation.

This 25–400 percent requirements would prohibit effectively any merger between a small corporation and a large one, and would prohibit the stockholders of a small corporation from disposing of their stock to a larger listed corporation in a tax-free exchange.

The new law defines a closely held corporation as one in which 10 or less stockholders own more than 50 percent of the stock. Every other corporation

is "publicly held" and eligible for the benefits that are denied to closely held corporations.

5. Interest deductions

A determined study of section 275, and 312 (d) and 312 (c) of H. R. 8300 reveals the fact that if a lender owns, directly or indirectly, 25 percent or more of the common stock of a corporation to whom it lends money, and the obligation is subordinated to the claims of general creditors, the interest paid on the loan could not be deducted by the corporation.

This hits directly at closely held corporations whose stockholders must lend money to their firms under subordination agreements.

6. Accumulated earnings tax

The ney law eliminates our concern over section 102 of the Internal Revenue Code, by substituting a new number for it, section 531–536. The new provisions ease the situation somewhat, but again discriminate against closely held corporations by providing that all corporations having 1,500 or more stockholders are automatically exempt from the penalty surtax provisions.

Some of the new provisions are favorable and helpful to all business, but will not be entirely satisfactory until (*a*) all income retained for a reasonable use is exempted, and (*b*) they define clearly whether or not retention of income to expand into a new unrelated business is a reasonable accumulation.

7. Splitting corporations

Section 1731 of the House bill provides that corporations formed by transfer of assets from other corporations for the purpose of getting additional $25,000 surtax exemptions may not take such exemptions

Section 1731 hits closely held corporations there, and also by providing that corporations so formed may not be entitled to the $30,000 accumulation that is exempt from the provisions of the unreasonable accumulations surtax. This $30,000 accumulation is the most favorable provision relating to the unreasonable accumulations tax in the new law for small business.

8. Pension trusts

Section 501 (e) of the House bill deals with qualifications of employees as participants in a qualified trust. There are some notable and some helpful changes, but it discriminates against small employers in that it restricts many of them, while opening wide the gates for many larger employers. The restriction on small employers arises from the rigid percentage requirements in subsection (e).

9. Partnerships

Many of the companies in the smaller manufacturers' group are partnerships, and whereas the new law (sec. 701–777) purports to codify and clarify many of the vexing provisions that have resulted in endless litigation, nevertheless there are some partnership provisions that leave the partners worse off now than under the old law.

(*a*) *Interest of a retired or deceased partner.*—Under section 736 (a), amounts received during the first 5 years after the partner's retirement or death will be taxed to him or his estate. But any payments paid to him or his estate after the 5-year period are gifts of the remaining partners and fully taxable income to them. We object to this arbitrary distinction in time, particularly in view of the fact that many partnerships even now are making such payments more than 5 years after partners retired. For the most part, these payments represent a share of earnings he helped earn while a partner, and the provision automatically subjects the remaining partners to tax on income that the retired or deceased partner earned while still a partner.

(*b*) *Transactions between partner and partnerships.*—Under the new law they are treated as separate entities (sec. 707). Thus, sale by a partner to a partnership (or vice versa) results in gain or loss to one or the other, unless the partner involved is a controlling partner. A controlling partner owns 50 percent or more of the partnership interest and is entitled to 50 percent or more of the profits. Guaranteed salaries paid to partners (sec. 707 (c)) are now distinguished from any distribution of his partnership interest; and taxable to him upon receipt, rather than at the end of the partnership year; and are subject to the Treasury's norm of reasonableness. It is not clear how you would treat any "salary" paid a partner in excess of an amount found to be "reasonable."

(*c*) There are several sections which purport to clarify, but which give rise to more uncertainty, to complicated accounting problems, and some very unneces-

sary valuation problems. These sections relate to basis of partnership interest, contributed property, distributions to partners, and computation of partners' distributive shares.

10. Valuation of estates

Small businesses, whether corporations, partnerships, or proprietorships, are very sensitive to estate-tax provisions, because frequently the application of the estate tax might be the difference between a business continuing and not continuing. Thus, we are considerably alarmed over the change in the optional valuation of estates for estate-tax purposes.

Under present law the estate has an option to use the value at date of death or 1 year after the date of death. Under section 2032 of H. R. 8300 the estate may exercise this option only if the value of the gross estate a year after death has declined to 66⅔ percent or less of the value of the gross estate at death. This figure is arbitrary and rigid and should be removed from the code.

These are some of the provisions that render H. R. 8300 so unsatisfactory to smaller manufacturers that our council would prefer the present law to the enactment of H. R. 8300.

But our disappointment with the new law is more concerned with what is not in the law even, than with some of the intolerable provisions we have outlined. Here are just three major items proposed to the Ways and Means Committee by several groups of small-business men and by the House and Senate Small Business Committees that were not acted upon.

11. Corporation surtax exemptions

We feel that small businesses could operate under conditions in which they could accumulate enough working capital to enable them to grow if the corporate surtax exemption was applied to all net income up to $100,000 rather than to $25,000 as at present. Our estimate is that this would cost approximately $930 million which we feel is a small price to pay for the incentives to more production and employment on the part of a group which constitutes 96 percent of the business community.

12. The Mills plan

We feel that the Mills plan for accelerated payment of corporate income taxes should be eliminated, not aggravated.

Most small corporations, and especially closely held corporations, do not have the accessibility to the money market that is enjoyed by our larger brothers with the result that we are forced to pay higher rates of interest in order to be able to pay the tax in 2 payments within 6 months after the close of the taxable year rather than in the 4 quarterly installments in the law prior to the adoption of the Mills plans.

Instead of giving us the relief asked in respect of this provision, H. R. 8300, at section 6016, aggravates the situation by "out-Millsing the Mills plan." It would do this by accelerating again the payments made by corporations, starting on a graduated scale until we reach the point wherein all corporations would again pay their tax on a quarterly basis but instead of paying it in the 4 quarters of the year following the taxable year, they would pay the first 2 quarters during the taxable year and the last 2 quarters during the first half of the following year.

This has two very harmful effects on most of the closely held corporations:

(*a*) It requires an estimate of net income in order that the tax might be payable before the net income is realized.

(*b*) Most of our smaller businesses operate on the calendar-year basis and under the terms of section 6016 of H. R. 6300 every corporation on the calendar basis would be obliged to pay 110 percent of 1 year's taxes in each of the next 5 years. This means that at the end of 5 years every corporation in our group will have paid a half year's taxes over and above the amount for which it is liable, and there is no year in which it will pay less than 100 percent until it has gone out of business, or until the year after forever.

13. Corporate tax rate

A great many associations and organizations of small-business men appealed to the House Ways and Means Committee to reduce the corporate rate to at least 50 percent from the current 52 percent. However, in H. R. 8300 the rate is continued at 52 percent and we feel that this is most harmful to the small-business man in terms of his morale in trying to grow by being constantly reminded that

in his business he is the junior partner and the United States Government remains the senior partner.

We feel that all 13 of the proposals mentioned are worthy of the closest consideration by the Senate Finance Committee in the interest of the small businesses of the United States, which are spread throughout every State in the Union, and which comprise 96 percent of the entire business community.

OHIO CHAMBER OF COMMERCE,
Columbus, April 23, 1954.

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

To all Members of the Senate Finance Committee:

We understand that the Senate Finance Committee will soon conclude its hearings on the legislation revising the Internal Revenue Code (H. R. 8300).

We submit for the committee's consideration the enclosed recommendations of the Ohio Chamber of Commerce as incorporated in letters to Senators Bricker and Burke of Ohio.

Respectfully,

C. I. WEAVER.

OHIO CHAMBER OF COMMERCE,
Columbus 15, Ohio, April 23, 1954.

Hon. JOHN W. BRICKER and Hon. THOMAS A. BURKE,
United States Senators, Senate Office Building,
Washington, D. C.

DEAR SENATORS: We have had occasion previously to express to you the support of the Ohio Chamber of Commerce for the major objectives of the bill making extensive revisions in the Internal Revenue Code (H. R. 8300) which is now under consideration by the Senate Finance Committee.

As we have said before, we regard the bill as beneficial in improving administrative and compliance features, by removing many inequities that have crept into present law, by closing some loopholes and by giving some measure of relief to all classes of taxpayers. After serious study by our Federal taxation advisory committee, however, we believe changes are called for to improve the bill, and we are taking this means of presenting our supplementary views. They were presented by our counsel, Mr. C. D. Laylin, in his appearance as a witness before the Finance Committee. Mr. Laylin, however, spoke not only for the Ohio Chamber of Commerce, but for other State chambers associated with the Council of State Chambers of Commerce. We felt that you would appreciate having this direct expression of an Ohio business viewpoint.

The recommendations of the Ohio chamber are as follows:

1. That the method of alleviating the double taxation of corporate earnings, embodied in sections 34 and 116 of the bill, being consistent with that which has been repeatedly advocated by the Ohio Chamber of Commerce and the State chambers is approved, though the degree of relief falls short of that for which we had hoped and to which we looked forward.

2. That we approve the attempt to make more flexible the depreciation deduction as embodied in section 167 of the bill, as a step in the right direction, though the committee adheres to the position of the State chambers that, in principle, the taxpayers should be allowed to exercise discretion in the choice of method and rate, within the limits of sound and consistent accounting.

3. We wish to register disappointment that, for asserted revenue reasons, the bill fails to recognize certain firm recommendations of the Ohio Chamber of Commerce and the State chambers. For example, the bill leaves unchanged the present law imposing a 2 percent penalty tax on consolidated corporation returns and the tax on 15 percent of intercorporate dividends. In supporting the bill as a whole, we advocate the elimination of these features, which would involve the deletion of the last sentence of section 1514 (a) and appropriate amendments of sections 243, 244, and 245.

4. The extension for 1 year of the 52 percent combined rate on corporate incomes is directly contrary to the positions of the Ohio Chamber of Commerce and the State chambers which is that corporate rates are too high and should not be continued at their present level beyond the date fixed in the present law.

If urgent revenue needs require extension of the 52 percent rate for 1 year as provided in the bill, the Ohio Chamber of Commerce accepts with great reluctance this feature of the bill with the understanding that this rate will expire at the end of 1 year.

5. The bill contains new provisions for declarations and advance payment of income taxes by corporations (secs. 6074, 6152, 6154, and 6655). This extension of the deplorable consequences of the Mills bill would amount to a further heavy increase in the tax payments of corporations with liabilities in excess of $50,000. In the case of non-excess-profit tax corporations it is a 10 percent increase in taxes for the next 5 years and will seriously deplete working capital.

6. The key employee provisions of the new qualification sections affecting employees' accident and health plans, and pension, profit-sharing and stock-bonus plans, would in practice discriminate against medium-sized corporations. This discrimination should be removed.

We see no reason for applying to group insurance plans the elaborate qualification provisions of the bill. We are opposed to the taxation of payments to employees under group insurance plans.

7. Section 309 of the bill imposes a penalty tax upon a corporation redeeming nonparticipating stock under certain circumstances. The tax should be imposed upon the stockholder as a dividend at ordinary rates rather than upon the corporation, and limited to amounts received under such circumstances in redemption of stock after the enactment of the bill.

8. Subsections (b) (2) and (c) (1) of section 359 of the bill impose a new condition upon the tax-free exchange of stock or property of a closely-held corporation for stock of an acquiring corporation, namely, that, immediately after the exchange the shareholders of the acquired or tranferor corporation shall hold at least 25 percent of the stock of the acquiring corporation outstanding prior to the transfer. This condition has no perceptible revenue or taxation purpose, and should be eliminated.

9. We believe wherever technical changes are made in the bill a reasonable period of time should be allowed to elapse before they become effective as law.

10. We believe that the Federal budget should be balanced through a continuing decrease in expenditures and that present conditions do not warrant an increase in the statutory limit on the public debt.

Again, permit us to express our support for the bill as a whole and our appreciation of the serious attention given by Congress to the many needed revisions and improvements in the Internal Revenue Code.

Our suggestions are submitted in a spirit of helpfulness and cooperation and we sincerely trust that you will find it possible to support them during Senate consideraiton of the measure.

Respectfully,

C. J. WEAVER, *President*.

FEDERAL TAXATION ADVISORY COMMITTEE

Freeman T. Eagleson, chairman, Eagleson & Laylin, 16 East Broad Street, Columbus, Ohio

Richard C. Baker, assistant to treasurer, tax division, the Timken Roller Bearing Co., 1835 Dueber Avenue, SW., Canton 6

Arthur F. Beckel, assistant to the president, Robbins & Myers, Inc., Springfield 99

George D. Brabson, tax attorney, the Ohio Oil Co., Findlay

E. H. Browning, real estate and tax agent, New York Central System, Cleveland 14

E. A. Cole, assistant counsel, the B. F. Goodrich Co., 500 South Main Street, Akron

William A. Crichley, controller, Diamond Alkali Co., 300 Union Commerce Building., Cleveland 15

Rufus Day, Jr., McAfee, Grossman, Taplin, Hanning, Newcomer and Hazlett, Midland Building, Cleveland

Bryan C. S. Elliott, tax division, United States Steel Corp., Pittsburgh, Pa.

Donald A. Finkbeiner, Finkbeiner & Stecher, Toledo Trust Building, Toledo

Paul L. Holden, Squire, Sanders & Dempsey, 1857 Union Commerce Building, Cleveland 14

Thomas P. Kearns, tax supervisor, American Steel & Wire Co., Rockefeller Building, Cleveland 13

Clarence D. Laylin, Eagleson & Laylin, 16 East Broad Street, Columbus

John C. Martin, CPA, Keller, Kirschner, Martin & Clinger, 33 North High Street, Columbus
R. H. Miner, assistant secretary, Goodyear Tire & Rubber Co., 1144 East Market Street, Akron 16
Frank Morfoot, assistant secretary, Owens-Illinois Glass Co., Ohio Building, Toledo 1
Frank R. Pitt, secretary, the DeVilbiss Co., Toledo 1
D. E. Reichelderfer, controller, Armco Steel Corp., Middletown
L. F. Scholley, assistant controller, Cleveland Electric Illuminating Co., Cleveland.
William A. Stark, vice president and trust officer, Fifty-Third Union Trust Co., Cincinnati
Carrol L. Wilson, director of finance, the Champion Paper & Fiber Co., Hamilton

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STATEMENT BY REPRESENTATIVE T. A. THOMPSON, 7TH DISTRICT, LOUISIANA

Mr. Chairman, I would like to place in the record remarks concerning sections 631 and 272, contained in H. R. 8300, as passed by the House. Sections 631 and 272 introduce a new requirement that certain administrative and other expenses (including interest and taxes) be charged against the capital gain instead of being deductible from gross income. I am very interested in the subject matter because many timber owners in my district, especially the smaller owners and operators strenuously object to this new requirement. I understand the timber owners all over the country are likewise objecting. They insist that in the code the treamtent of timber should be separated from that of coal and are equally insistent that no change be made in the present provisions of section 117K of the 1943 tax act insofar as timber is concerned.

My constitutents tell me the effect of the charges will be to discourage private forestry programs. Further, they say it would impose almost impossible accounting requirements on timber owners, especially on small taxpayers who cannot afford expensive legal and accounting advice. Finally, they say it would discriminate against forest owners as compared to others who have capital gains.

Apparently the purpose of sections 631 and 272 was to permit the deduction of certain expenses from capital gain where the taxpayer has no ordinary income against which to apply them.

Some other timber owners have proposed that under section 631 (b), the date of disposal should be changed from the date of the cutting contract to the date the timber is cut. For your kind consideration and I hope adoption, I submit the following proposed amendment:

PROPOSED AMENDMENT TO SECTIONS 272 631 OF H. R. 8300 WITH RESPECT TO CAPITAL GAINS ON TIMBER

(Omit the language shown in black brackets and add language italicized.)

SEC. 272. [CUTTING OF TIMBER AND] DISPOSAL OF COAL [OR TIMBER].

[(a) Where the cutting of timber by a taxpayer is considered a sale or exchange under section 631 (a), no deduction shall be allowed for administrative and other expenses, incurred in the taxable year such timber is cut, in connection with the holding and quality measurement of such timber.]

[(b)] Where the disposal of coal [or timber] by the taxpayer is covered by section 631 [(b)] *(c)*, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. This subsection shall not apply to any taxable year during which there is no production, or income, under the contract.

SEC. 631. GAIN OF LOSS IN THE CASE OF TIMBER OR COAL.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or

loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. [plus the deductions disallowed under section 272.] Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate.

(b) DISPOSAL OF TIMBER [OR COAL] WITH A RETAINED ECONOMIC INTEREST.—(*1*) In the case of the disposal of timber [or coal (including lignite),] held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber [or coal], the difference between the amount realized from the disposal of such timber [or coal] and the adjusted depletion basis thereof [plus the deductions disallowed for the taxable year under section 272] shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber [or coal]. *The date of cutting of such timber shall be deemed to be the date of disposal.*

(2) To the extent not deducted from other income of the taxpayer as business expenses, expenditures attributable to the making and administering of the contract under which the disposition occurs and to the preservation of the economic interest retained under such contract may be added to the adjusted depletion basis in determining gain or loss.

(c) DISPOSAL OF COAL WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal, the difference between the amount realized from the disposal of such coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. [In the case of coal,] This subsection shall not apply to income realized by any owner as a coadventurer, partner, or principal in the mining of such coal, and the word owner means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, [in the case of coal,] for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deduction under section 535 (b) (6) or section 545 (b) (5)).

DETROIT 23, MICH., *April 22, 1954.*

CHAIRMAN OF FINANCE COMMITTEE,
United States Senate, Washington, D. C.

GENTLEMEN: Last year a Mongoloid child was born to us (one of 300,000 in the United States). At the specific recommendation of 3 physicians, this child was placed in a home for care at a cost of $100 per month.

This year a deduction of $1,103 was disallowed on our income-tax return on the basis that this child was not at the home for the primary purpose of treatment and I was given to understand if he had tuberculosis, cerebral palsy, or any other affliction which today has a known cure or treatment it would be allowed under the present law. It is unfortunate that to date there is no relief for Mongoloids and many other congenitally defective children. However, since medical experience has proved the necessity for custodial care, I firmly believe

the parents of such children should receive tax relief. This child was sent to us by God like a normal child and we wish to assume the responsibility for his care even though it means a long, hard sacrifice.

It is our recommendation that serious consideration be given to this problem inasmuch as there are 5 million physically or mentally handicapped children in this country or 12.4 percent of school-age children. With the increased birthrate the number will continue to grow and unless some relief is provided, more of these children will be placed in public institutions at a cost considerably more than the $250 tax credit which would be allowed by the Government to parents.

Moreover, at approximately the age of 6, this child must be sent to a special school in the hopes that he can be rehabilitated. The States provide no special schools and so the parent is again faced with heavy expense for an undetermined period of years.

The tax allowance means a credit to us of approximately $25 for every hundred dollars expended or about $250, 2½ months of care.

We are aware of the abuses which might result from a revision of the law "for the medication and prevention of disease" but congenitally defective children are so seriously handicapped that custodial care is a necessity.

We respectfully request that serious consideration be given this problem in the revision of H. R. 8300.

Most respectfully,

LEBERTHA MAYENE SELINGER.
Mrs. Paul J. Selinger.

WILLIAM O'NEILL KRONNER,
ATTORNEY AND COUNSELOR,
Detroit 26, April 21, 1954.

Hon. HOMER FERGUSON,
Senate Office Building,
Washington, D. C.

DEAR SENATOR: Supplementing Mrs. Lulu Bachman's letter to you under date of April 15, and your reply thereto under date of April 19, relating to H. R. 8300, section 1235, providing for sale or exchange of patents by the inventor, and H. R. 7646 providing for a percentage depletion allowance for patents, which are now in the Senate Finance Committee, I am enclosing a memorandum prepared by Mrs. Ernest E. Wemp and the undersigned, which I respectfully request that you present and discuss with Senator Milliken, chairman of the Senate Finance Committee.

I note that you have already taken time out from a very busy schedule to discuss this matter with Mr. J. Marvin Haynes of the law firm of Haynes & Miller, Washington, D. C., and I want you to know that Mrs. Wemp, Mrs. Bachman, and the undersigned are most grateful. I am informed that either Mr. Haynes or his associate, Mr. Miller, will contact you further on Thursday or Friday of this week.

While some of the contents of the enclosed memorandum may be cumulative, the outcome of the pending legislation is of such great importance to Mrs. Wemp, whose position is consistent with the traditional Republican idea of encouraging American inventors and protecting their widows, that she should be afforded every opportunity of stating her position and I know that you will follow through by presenting same as incorporated in the enclosed memorandum, as above set forth.

Be assured, Senator, of our gratefulness for your many, many courtesies, your devotion to the public interest and our every good wish for your continued success, so richly deserved.

Respectfully yours,

WILLIAM O'NEILL KRONNER.

MEMORANDUM RE H. R. 8300, SECTION 1235, PROVIDING FOR SALE OF EXCHANGE OF PATENTS BY THE INVENTOR, AND H. R. 7646, PROVIDING FOR A PERCENTAGE DEPLETION ALLOWANCE FOR PATENTS

I. SECTION 1235

Section 1235 proposes to allow an inventor to treat the income from the sale or exchange of a patent or application therefor as a capital gain only if (1) he retains no interest whatsoever in the patent except to the extent that the pur-

chase price may be related to the productivity of the patented invention, and (2) the entire proceeds of such sale or exchange are received by the inventor within a 5-year period from the date of such sale or exchange.

Under the present law, it is well established by judicial decisions that if an amateur inventor grants an exclusive license to another to make, use and sell his patented invention, and agrees to receive as payment therefor royalties measured either by the number of units of the invention sold or by the unit price which the assignee receives from sales of the patented invention, such payments constitute capital gain to the inventor, taxable at capital gain rates. The foregoing rule is not applicable to exclusive licensing agreements entered into by professional inventors, since they are deemed to be primarily engaged in the business of inventing and holding their inventions for sale.

Section 1235 proposes a substantial change in existing law, broader in the respect that it applies equally to amatuer and professional inventors, but most seriously restrictive in that it requires all the proceeds of sale to be received by the inventor within 5 years. Under present law, an inventor may receive royalties from exclusive licensing agreements during the entire life of his patent and have such royalty payments taxable at capital gain rates.

The report of the House Ways and Means Committee with respect to section 1235 states that its purpose is "to provide a larger incentive to all inventors to contribute to the welfare of the Nation."

To the extent that the difference in tax treatment of sales of patents by amateurs and professional inventors is eliminated, the section is an improvement over the present law, but it will fall far short of providing the "larger incentive to all inventors" mentioned in the committee report. Indeed, its effect will be the opposite.

In the first place, the 5-year period is so short that it will seriously deter the proper commercial development and exploitation of new inventions. It can be predicted with considerable certainty that the establishment of a 5-year royalty limit, in order to obtain capital-gains tax treatment, will retard the development and marketing of inventions. Instead of promptly entering into contracts of sale with established manufacturers, inventors can be expected to try to exploit their own inventions, often with inadequate capital. They will be tempted to use the 5-year period after obtaining a patent to test for themselves the extent to which their inventions are likely to be commercially successful. The financial hazards and the likelihood of failure of such understakings by inventors themselves will almost certainly delay or prevent altogether the commercial development of many a scientific advance.

On the other hand, since patents run for a period of 17 years, the existing law encourages inventors to sell under exclusive license agreements their patented inventions as promptly as possible to well-established national manufacturing organizations. This is true because a sale with reservation of royalties for the full life of the patent places the inventor and the manufacturer-buyer on an economic parity. The inventor under a 17-year exclusive license agreement shares fully in the success of his invention and the manufacturer-buyer has no incentive to delay commercial exploitation of the invention.

In contrast, the 5-year period proposed by section 1235 will place inventors at the mercy of persons financially and otherwise capable of commercially developing his invention. A purchaser, under the 5-year royalty contract contemplated by section 1235, will have every incentive to drag his feet in popularizing and promoting the sale of the invented article during the first 5 years. Then, when free of his obligation to pay the inventor further royalties, he can step up promotional activities with respect to the invention and reap the harvest of profits for himself, leaving the inventor in the unenviable position of having created the new device only to lose the valuable economic rewards of his genius.

It may be that the House Ways and Means Committee thought that if an inventor wanted to share in the reward throughout the life of the patent, he would be free to enter into a licensing agreement rather than a contract of sale. But this is not realistically true. Many manufacturers rightly insist upon complete ownership and control of the patents covering the invented devices which they undertake to manufacture. This is the reason the so-called exclusive license agreement which has been consistently held tantamount to a sale or assignment is so common a form of patent conveyance. Under such agreements the inventor parts with all his property rights in the patent and the invention, retaining only a contract right to receive a portion of the profit earned by his invention during the life of the patent. Yet under the House bill he will be required to report the entire purchase price as ordinary income. And why? Solely because the payments of the purchase price extend for more than 5 years.

Thus the inventor is faced with a Hobson's choice: give up all property right in his invention and receive royalties taxable at capital-gains rates during the first 5 years while the use and value of the invention are in the developmental and promotional stage; or treat the royalties as ordinary income, subject to tax rates which over 17 years may or may not yield more, net of income taxes, than royalties for 5 years at capital-gain tax rates. In neither instance has the inventor received just compensation for his genius.

There is another very objectionable feature of section 1235. Its restrictions with respect to capital gains treatment of royalties from the sale of a patent apply to any persons whose efforts created such property. Many inventions have reached the patentable stage only by reason of outside financial aid to the inventor. Typical contracts for necessary financial aid provide that the person advancing the risk capital will share in the ownership of the resulting invention. A part of the reward for assuming the great financial risk involved is the capital gains treatment accorded the proceeds of a subsequent sale of the patent or application. Denying capital-gains treatment to financial backers will make persons with financial means more than ever reluctant to assist potential inventors.

Perhaps section 1235 is not intended to restrict the right of a financial backer to have unrestricted capital-gains tax treatment of a sale of his interest in the patent. But without a definition of the phrase "any person whose efforts create such property," the effect of the section is uncertain.

In any event, to the extent that inventors themselves are restricted in their right to have capital-gains tax treatment, it is made more difficult for them to obtain financial aid while they are creating a patentable invention.

When Congress had before it for consideration in 1950 a proposal to exclude inventions, patents, and designs from the definition of a capital asset under section 117 (a) (1) of the 1939 Revenue Code, the Senate Finance Committee rejected it and stated:

"The House bill also would have treated as ordinary income gains from the sale of an invention or patent by the occasional inventor. Your committee believes that the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill and therefore, the words 'invention', 'patents' and 'design' have been eliminated from this section of the bill."

The same reasoning applies to section 1235. It ought either to be rejected by this committee or the 5-year period in subsection (a) should be extended to the 17-year period during which the patent is effective.

II. H. R. 7646, TO PROVIDE A PERCENTAGE DEPLETION ALLOWANCE FOR PATENTS

On February 2, 1954, H. R. 7646 was introduced in the House of Representatives and was referred to the Committee on Ways and Means.

In the revision of the Internal Revenue Code contained in H. R. 8300 no provision has been made for a percentage depletion allowance for patents. It is submitted that the proposals made in H. R. 7646 ought to be included in H. R. 8300.

A patent has a 17-year life, at the end of which time the invention protected by the patent becomes public property. Under present tax law the cost to the inventor of obtaining a patent is depreciable. However, the actual cost usually represents only a small part of the intangible cost and value to the inventor of the invention covered by the patent. Thus, virtually all the profits derived from a patent over its life are subject to income taxes without any substantial depreciation deductions for cost

The national economy requires that potential inventors be given every reasonable encouragement and incentive to devote their energy and skill to the development of new devices, products, and processes.

Percentage depletion allowances have long been granted to oil, gas, and other mineral properties in order to stimulate exploration and development. New inventions are at least equally valuable to the national interest. It is just as important to stimulate creative genius to invent new devices, products, and processes as it is to encourage the discovery and extraction of our mineral reserves.

A percentage depletion allowance amounting to 15 percent of the gross income from a patent during its life is a reasonable incentive. It can be expected to have the same stimulating effect upon the development of invaluable inventions that the 27½ percent depletion allowance has had in developing the oil and gas industry in this country.

PHILLIPS, COUGHLIN, BUELL & PHILLIPS,
ATTORNEYS AT LAW,
Portland, Oreg., April 30, 1954.

Re H. R. 8300

Hon. GUY CORDON,
United States Senator,
Senate Office Building, Washington, D. C.

DEAR SENATOR CORDON: The above legislation was adopted by the House as a part of the general revision of the income-tax statutes.

However, it has come to our attention that the House of Representatives apparently did not give full consideration to the problems of title-insurance companies in connection with this revision.

You will recall that the new act provides a certain dividend credit on dividends received by individuals under section 34 of the proposed revision. This credit, however, is denied to stockholders of all insurance companies which apparently would include title-insurance companies. Corporations receiving dividends are also allowed a deduction under section 243 of the proposed revision but this is denied all insurance companies under section 246 and we assume would deny it to title-insurance companies.

Subchapter L of the proposed revision treats particularly with insurance companies, part I thereof being life-insurance companies, part II being mutual insurance companies, and part III being other insurance companies. We assume that the restrictive provisions under 34 (c) (1) and 246 (a) (1) were primarily intended to apply to life-insurance companies and mutual insurance companies which enjoy certain accounting privleges for tax-reporting purposes by reason of certain loss reserves which they are required to keep under said regulations.

Title-insurance companies, however, are not required to have such loss reserves and apparently the only reserve which is required of them under Oregon Insurance Commissioner regulations is a reinsurance reserve of 3 percent of their premiums which is frozen for a period of 180 months and then released for corporate purposes. At the time it is released it becomes corporate income and is subject to taxation.

The Title & Trust Co. of Portland, Oreg., is sending to you a memorandum covering the full extent of this matter and we hope that you may be able to assist in having the matter corrected in the tax bill which is already before the Senate. We believe that title-insurance companies which report on the same basis as other corporations in general should enjoy the same deductions or credits for dividends paid as other corporations and that their stockholders should enjoy the same credits as stockholders of other corporations reporting their income tax on a similar basis.

With best personal regards to you and Bob Parkman.

Very truly yours,

CLARENCE D. PHILLIPS.

TITLE & TRUST CO.,
Portland, Oreg., April 12, 1954.

Re H. R. 8300.

Mr. COLIN F. STAM,
Chief of Staff, Joint Committee on Internal Revenue Taxation,
1011 House Office Building, Washington, D. C.

DEAR MR. STAM: Enclosed herewith for your consideration and for presentation, to the Senate Finance Committee is a memorandum suggesting amendments to sections 34 (c) (1) and 246 (a) (1) of the proposed Internal Revenue Code of 1954, together with a statement of the reasons why such amendments should be made. It is believed that the sections now proposed are defective from a technical standpoint and cover corporations no intended to be covered.

This presentation is made on behalf of the Oregon Land Title Association, a trade association representing all of the seven title-insurance companies qualified to do business in this State.

Respectfully,

BUDD G. BURNIE, *President.*

MEMORANDUM RE PROPOSED AMENDMENTS TO SECTION 34 (c) (1) AND 246 (a) (1), H. R. 8300, RELATIVE TO DIVIDENDS PAID ON STOCK OF OREGON TITLE INSURANCE COMPANIES

I. PROPOSED AMENDMENTS

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

"(a) DEDUCTION NOT ALLOWED FOR DIVIDEND FROM CERTAIN CORPORATIONS.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

II. REASONS FOR THE PROPOSED AMENDMENTS

A. *Purpose of provisions.* As explained in the House committee report the general purposes of section 34 is to afford some relief from the double taxation of corporation dividends. The purpose of subsection (c) of section 34 is explained on page 6 of the report as follows:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations. Thus, it does not apply to dividends of exempt farm cooperatives or to distributions which have been allowed as a deduction (in effect treated as interest) to a mutual savings bank, cooperative bank, or building and loan association. Moreover, the dividend-received credit is not available to nonresident alien individuals not subject to the regular individual income tax."

Section 34 contains provisions not in the present law, allowing to individual stockholders a dividends-received credit for part of the dividends received from corporations subject to the regular tax rates. Sections 243, 244, and 245 contain provisions, similar to those in section 26 (b) of the present law, allowing to corporate stockholders deductions for a portion of the dividends on stock received from corporations subject to the regular tax rates.

Undoubtedly, it was for the purpose stated in the above quotation that the House Committee inserted in section 34 (c) (1) and in section 246 (a) (1) the limitation regarding "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following);"

As will be shown clearly below, however, the language used is too broad in its operation and will include insurance companies which are subject to the income tax and surtax rates applicable to corporations in general and whose dividends presently are subject to double taxation.

B. *Taxation of insurance companies.* Subchapter L of chapter 1 contains the provisions for taxation of insurance companies, under four separate parts, as follows:

Part I covers life insurance companies and in general continues for 1 year the present provisions of the law.

Part II covers mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies) and in general continues the present provisions of the law.

Part III covers other insurance companies and in general continues the present provisions of the law.

Part IV covers provisions of general application and in general continues the present provisions of the law.

Under the present law and under the House bill, insurance companies which are covered by parts I and II, in general life insurance and mutual companies, are not subject to the regular corporation income-tax rates. On the other hand, section 831 of the House bill provides as to "other companies" covered by part III as follows:

"(a) *Imposition of tax.*—Taxes computed as provided in section II shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction or underwriting costs as may be provided) is refundable on cancellation or expiration of the policy."

Section 11 covers the tax imposed on "corporations in general." Accordingly, insurance companies covered by part III pay the regular corporation tax rates.

C. *Title insurance companies.* These companies are covered by part III and pay the regular corporation tax rates. Section 832 provides, as does the present law, that the gross income of such companies shall include (A) the gross amount earned during the year from investment income and from underwriting income, (B) gain during the year from the sale or other disposition of property, and (C) all other items constituting gross income under subchapter B. Deductions are allowed for losses incurred, expenses incurred, and other deductions comparable to the deductions allowed to ordinary corporations.

By reason of the nature of their business, title-insurance companies in the State of Oregon operate in the same manner as corporations in general. They maintain extensive title records and before a title policy is issued a careful search of the record is made. A single premium is charged for the policy and substantially the entire amount immediately constitutes taxable income. A title policy is not renewable at stated intervals like most insurance policies but continues in force indefinitely. Title-insurance companies in Oregon at the present time are required by law to set aside each month as an unearned premium or reinsurance reserve 3 percent of their gross premiums. After the expiration of 180 months from January 1, 1942, that portion of the unearned premium or reinsurance reserve established more than 180 months prior shall be released and shall no longer constitute part of the unearned premium or reinsurance reserve, and may be used for any corporate purpose, thus making such amounts released from such reserves subject to the regular corporation tax rates in such year.

Such reinsurance reserves of 3 percent as presently required by the insurance commissioner of Oregon, are not "loss reserves," and should not be confused with reserves required of life-insurance companies or mutual companies. The reinsurance reserve of a title company in Oregon is strictly limited in both amount and time, and after the period of 180 months becomes income to the corporation, and a part of the fund out of which dividends are paid to its stockholders.

Because of the extensive research in connection with each title policy, the largest item of expense is labor, in common with corporations in general. As a result of this and efficient title practices, losses rarely exceed 2 percent of annual premiums and thus do not present any unusual accounting problems. Oregon title-insurance companies do not use reserves in determining loss deductions for the purpose of computing net income. A loss deduction is determined on each separate situation in the light of the particular facts, and is taken only when the amount is definitely ascertained.

Accordingly, the net income of an Oregon title-insurance company, as computed under section 832 of the House bill (which is substantially the same as section 204 of the present Internal Revenue Code), would be substantially the same if its income were determined under other provisions of the law applicable to corporations in general.

Oregon title-insurance companies do not receive any special tax benefits or favored treatment; their income-tax burden is fully as heavy as that of corporations in general. They do not receive any special benefits such as, for example, percentage depletion deductions afforded to natural resource companies.

Any fair-minded survey of the facts will disclose clearly that title-insurance companies in the State of Oregon bear their full share of the Federal income-tax burden. They definitely present a situation "in which double taxation actually occurs" and there is no sound basis in logic or equity for discriminating against them, as the House bill does.

Accordingly, if no change is made in the provisions here in question, this company will continue to be subject to double taxation in the same manner as corporations in general, without any relief whatever to its stockholders. We respectfully submit that this treatment would be grossly inequitable and discriminatory and, we believe, would be contrary to the real intention of the legislators.

In this connection it should be noted that under the present law Oregon title-insurance companies are allowed a dividends-received deduction for dividends received from any titue-insurance subsidiaries, while under the proposed House bill they would be allowed no deduction. Accordingly, the House bill not only would deny the new dividends-received credit to its shareholders but would add a very great tax burden on such companies which is not imposed by the present law.

CONCLUSION

It is respectfully submitted that the provisions of sections 34 (c) and (1) and 246 (a) (1) of House bill 8300 would result in unjust discrimination as to Oregon title-insurance companies and should be amended. It is believed that their inclusion in the exceptions was due to a misunderstanding or to an oversight.

THE J. L. HUDSON CO.,
Detroit, Mich., April 15, 1954.

Hon. HOMER FERGUSON,
Senate Office Building, Washington, D. C.

DEAR SENATOR FERGUSON: The Senate Finance Committee at the present time is conducting very brief hearings on H. R. 8300, the Internal Revenue Code of 1954, a bill revising the internal revenue laws of the United States. Certainly this legislation was a monumental undertaking for the House Ways and Means Committee, and that group is to be commended for the efforts which it was required to put forth in order to complete this important task.

However, there are many things in the bill which were never discussed at any of the hearings before the Ways and Means Committee and which did not appear in any of the publications of any of the services which attempted to report on pending tax legislation. It is almost impossible to read and understand this bill in time to make adequate protests against those provisions which seem inequitable to taxpayers. There are three provisions, however, which are very disturbing to the J. L. Hudson Co.

One provision is the changed payment date covered in sections 6016, 6074, 6154, and 6155 of the bill. These sections require the acceleration of the payment of corporate income taxes over the next 5 years in the following manner:

In the year 1955 the entire tax liability for the taxable year 1954 must be paid, plus 10 percent of the estimated tax for the taxable year 1955.

In the year 1956, 90 percent of the tax for the taxable year 1955 must be paid, plus 20 percent of the estimated tax for the year 1956.

This continues until 1959, when it will be necessary to pay 60 percent of the tax due for the taxable year 1958, plus 50 percent of the estimated tax for the taxable year 1959.

In 1960 the taxpayer will pay 50 percent of the tax for the taxable year 1959, plus 50 percent of the estimated tax for the taxable year 1960.

In other words, during the 5 years, 1955 to 1959, inclusive, it will be necessary for a corporate taxpayer to pay in the aggregate one-half year's additional income taxes. This is a very serious matter because it robs corporations of working capital needed for the conduct of their business. It is extremely unfair to make any corporate taxpayer pay an additional one-half year's income tax, which is nonrecoverable until the year of dissolution or failure.

Another provision which disturbs the J. L. Hudson Co. is the requirement of section 461 of H. R. 8300. Under existing law, an accrual-basis taxpayer is required to accrue a deduction for taxes at the moment the lien for taxes attaches to the property. In Michigan the lien attaches on January 1 of each year.

Under the provisions of section 461 of H. R. 8300, an accrual-basis taxpayer is required to accrue taxes for the period that the taxes cover. In Michigan taxes which attach to the property on January 1 of each year are payable in August and December of that year, and cover the period up to June 30 of the subsequent year. Therefore, under the provisions of H. R. 8300, taxes must be accrued during the period July 1 of one year, through June 30 of the subsequent year. This will deny accrual-basis taxpayers in Michigan a deduction for

taxes for a minimum of 6 months in the year of change to a maximum of 1½ years. The J. L. Hudson Co. is a fiscal-year corporation whose year ends January 31 of each year. Real-estate taxes become a lien on property on January 1 of each year, as I previously stated. Therefore, the J. L. Hudson Co. is required by law to accrue, for instance, in our fiscal year 1953, ending January 31, 1954, the taxes which must be paid in August and December of 1954 and which cover the period ended June 30, 1955. Under the provisions of this law, we will not be permitted to accrue taxes again until July of 1955, and during our 1955 fiscal year, ending January 31, 1956, we would be entitled to only 7 months' deduction for taxes. This would be a crushing burden to the J. L. Hudson Co. It would cost us substantially over $1 million in additional income taxes, nonrecoverable ever. Section 461 should be changed so that any taxpayer will continue to have the right to deduct 1 full year's property taxes in each taxable year, irrespective of the provisions of section 461.

Another very disturbing change is the provision in section 167E, on depreciation, wherein it is stated:

"Unless the useful life of any property, on which the rate of depreciation is based, determined to be appropriate by the Secretary or his delegate, differs from the useful life used by the taxpayer by more than 10 percent, the rate for such property for such taxable year shall be the rate as used by the taxpayer."

A 10-percent margin for differences of opinion with respect to anything as indeterminable as the useful life of property is so small as to make this provision render ineffective the supposed beneficial effects of the new depreciation method. This 10-percent requirement should be stricken from the bill.

It seems to us at the J. L. Hudson Co. that the 3,000 changes in the code produced by H. R. 8300 makes such a monumental job of study for all taxpayers that any consideration of H. R. 8300 by the Senate should be delayed until fall, so that all taxpayers will have adequate time to know and understand the contents of the bill and to make their opinions available to the Senate Finance Committee and the Members of the Senate.

However, we will appreciate your best efforts to correct the glaring inequities in sections which have been discussed here.

Sincerely,

E. C. STEPHENSON, *Vice President.*

UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
April 19, 1954.

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

DEAR SENATOR: Mr. Charles L. Strouss, attorney at law, Title and Trust Building, Phoenix, has just written me concerning certain provisions in the proposed revision of the Internal Revenue Act. I quote below Mr. Strouss' remarks, and request that they be made a part of the record for consideration by the members of the Senate Committee on Finance:

"Section 115 (g) of the Internal Revenue Act (title 26, U. S. C. A., sec. 115 (g)) provides that if a corporation cancels or redeems stock at such time and in such manner as to make the distribution or redemption essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption shall be treated as a taxable dividend.

Under subsection (3) of 115 (g), the foregoing provisions are made inapplicable to stock included in determining the value of the gross estate of the decedent to such an amount as is not in excess of the estate and succession taxes imposed because of such decedent's death; provided, that the value of the stock in such corporation comprises more than 35 percent of the value of the gross estate of the decedent. I am advised that the amendment to this subsection (3) under the proposed new Internal Revenue Act will add another condition precedent to the amounts of the exemption. That is, that in order for such redemption of stock of a decedent to come under the provisions of subsection (3), the estate of the decedent must own 75 percent of the issued stock of the corporation.

As you know, this provision is aimed at family corporations. However, it seems to me that it will impose an undue hardship especially where the decedent may have owned stock in several closely owned corporations. We had a good example at present in our office in the estate of Harry Nace, Sr. Harry, at his death, held stock in some 13 closely held corporations. In not over 3 of them

did he own 75 percent of the stock. The estate is compelled to redeem a substantial amount of the stock in order to pay its State taxes. If the redemption is treated as a taxable dividend, it will impose a tremendous penalty on the estate.

I suggest that the Senate proposal for the amendment of this section in 1950 is more equitable. See the report of the Senate Finance Committee, section 210 (1950)."

Yours very sincerely,

CARL HAYDEN.

TITLE GUARANTEE & TRUST CO.,
Birmingham, Ala., April 16, 1954.

Hon. LISTER HILL,
United States Senate, Washington, D. C.

DEAR SENATOR: I am enclosing herewith a memorandum suggesting amendments to the proposed Internal Revenue Code of 1954 (H. R. 8300) before it finally passes.

I would appreciate very much your reading this memorandum and using your influence to see that the bill is so amended before final passage that it will not discriminate against the stockholders of title insurance corporations which will be taxed in the same manner as other business corporations.

Yours very truly,

MACLIN F. SMITH, *President.*

MEMORANDUM RE PROPOSED AMENDMENTS TO SECTIONS 34 (c) (1) AND 246 (A) (1), H. R. 8300, RELATIVE TO DIVIDENDS PAID ON STOCK OF ALABAMA TITLE INSURANCE COMPANIES

I. PROPOSED AMENDMENTS

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"SECTION 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"SECTION 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

II. REASONS FOR THE PROPOSED AMENDMENTS

A. *Purpose of provisions.* As explained in the House committee report the general purpose of section 34 is to afford some relief from the double taxation of corporation dividends. The purpose of subsection (c) of section 34 is explained on page 6 of the report as follows:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations. Thus, it does not apply to dividends of exempt farm cooperatives or to distributions which have been allowed as a deduction (in effect treated as interest) to a mutual savings bank, cooperative bank, or building and loan association. Moreover, the dividend-received credit is not available to nonresident alien individuals not subject to the regular individual income tax."

Section 34 contains provisions not in the present law, allowing to individual stockholders a dividends-received credit for part of the dividends received from corporations subject to the regular tax rates. Sections 243, 244, and 245 contain provisions, similar to those in section 26 (b) of the present law, allowing to corporate stockholders deductions for a portion of the dividends on stock received from corporations subject to the regular tax rates.

Undoubtedly, it was for the purpose stated in the above quotation that the House committee inserted in section 34 (c) (1) and in section 246 (a) (1) the limitation regarding "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following);"

As will be shown clearly below, however, the language used is too broad in its operation and will include insurance companies which are subject to the income tax and surtax rates applicable to corporations in general and whose dividends presently are subject to double taxation.

B. *Taxation of insurance companies.* Subchapter L of chapter 1 contains the provisions for taxation of insurance companies, under four separate parts, as follows:

Part I covers life insurance companies and in general continues for 1 year the present provisions of the law.

Part II covers mutual-insurance companies (other than life or marine or fire-insurance companies issuing perpetual policies) and in general continues the present provisions of the law.

Part III covers other insurance companies and in general continues the present provisions of the law.

Part IV covers provisions of general application and in general continues the present provisions of the law.

Under the present law and under the House bill, insurance companies which are covered by parts I and II, in general life insurance and mutual companies, are not subject to the regular corporation income-tax rates. On the other hand, section 831 of the House bill provides as to other companies covered by part III as follows:

"(a) IMPOSITION OF TAX.—Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life- or mutual-insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction or underwriting costs as may be provided) is refundable on cancellation or expiration of the policy."

Section II covers the tax imposed on corporations in general. Accordingly, insurance companies covered by part III pay the regular corporation tax rates.

C. *Title insurance companies.* These companies are covered by part III and pay the regular corporation tax rates. Section 832 provides, as does the present law, that the gross income of such companies shall include: (*a*) The gross amount earned during the year from investment income and from underwriting income, (*b*) gain during the year from the sale or other disposition of property, and (*c*) all other items constituting gross income under subchapter B. Deductions are allowed for losses incurred, expenses incurred, and other deductions comparable to the deductions allowed to ordinary corporations.

By reason of the nature of their business, title insurance companies in the State of Alabama operate in the same manner as corporations in general. With respect to a large percentage of their business, they maintain extensive title records and before a title policy is issued a careful search of the record is made. A single premium is charged for the policy and the entire amount immediately constitutes taxable income. A title policy is not renewable at stated intervals, like most insurance policies, but continues in force indefinitely. Accordingly, there is no problem of unearned premiums.

Because of the extensive research in connection with each title policy, the largest item of expense is labor, in common with corporations in general. As a result of this and efficient title practices, losses rarely exceed a small percent of annual premiums and thus do not present any unusual accounting problems. Alabama title insurance companies do not use reserves in determining loss deductions for the purpose of computing net income. A loss deduction is determined on each separate situation in the light of the particular facts, and is taken only when the amount is definitely ascertained.

Accordingly, the net income of an Alabama title insurance company, as computed under section 832 of the House bill (which is substantially the same as

section 204 of the present Internal Revenue Code), would be the same if its income were determined under other provisions of the law applicable to corporations in general.

Alabama title insurance companies do not receive any special tax benefits or favored treatment; their income-tax burden is fully as heavy as that of corporations in general. They do not receive any special benefits such as, for example, percentage depletion deductions afforded to natural resource companies.

Any fairminded survey of the facts will disclose clearly that title insurance companies in the State of Alabama bear their full share of the Federal income-tax burden. They definitely present a situation in which double taxation actually occurs and there is no sound basis in logic or equity for discriminating against them, as the House bill does.

Accordingly, if no change is made in the provisions here in question, title companies in this State will continue to be subject to double taxation in the same manner as corporations in general, without any relief whatever to its stockholders. We respectfully submit that this treatment would be grossly inequitable and discriminatory and, we believe, would be contrary to the real intention of the legislators.

In this connection, it should be noted that under the present law, these companies are allowed a dividends-received deduction for dividends received from its title insurance subsidiaries while under the proposed House bill it would be allowed no deduction. Accordingly, the House bill not only would deny the new dividends-received credit to its shareholders, but would add a very great tax burden on the companies themselves which is not imposed by the present law.

This is not a situation in which a taxpayer is afforded tax relief by electing to be taxed as an insurance company. Under the House bill, as well as under the present law, it has no choice but must compute its net income under subchapter L as an insurance company, even though it obtains no tax benefit from such treatment.

As an alternative, in the event that the provisions here in question are not changed so as to remove this discrimination, title insurance companies should be permitted to elect whether to be taxed under the provisions of subchapter L (with the corresponding burdens relative to dividends received from other title insurance companies and relative to dividends paid to its shareholders) or whether to be taxed under the general provisions relating to corporations in general. Without the right to make such an election, a title insurance company is forced to file its returns in a manner which affords it no tax benefits or relief, while at the same time subjecting it and its stockholders to tax burdens which do not apply to corporations in general.

CONCLUSION

It is respectfully submitted that the provisions of sections 34 (c) (1) and 246 (a) (1) of House bill 8300 would result in unjust discrimination as to Alabama title insurance companies and should be amended. It is believed that their inclusion in the exceptions was due to a misunderstanding or to an oversight.

BANK OF ST. LOUIS,
St. Louis, Mo., April 16, 1954.

Re H. R. 8300, New Internal Revenue Code

Hon. PRESCOTT S. BUSH,
Senator from Connecticut,
Senate Office Building, Washington, D. C.

DEAR PRES: There are two very objectionable sections to H. R. 8300. One is section 163, wherein the bill labels finance charges as interest, which is directly in conflict with the laws of the various States on the subject. This objectionable feature can easily be remedied if the suggestion offered by the American Bar Association is adopted.

Section 6223 of H. R. 8300 provides for secret Government tax liens. No secured lender should be deemed to have notice of the existence of the Government's lien unless and until it is recorded. Here again, the American Bar Association's suggested amendments—with which I am in full accord—should be adopted.

These two objectionable provisions can be changed so as to accomplish fully the end desired by Congress without penalizing lenders—mostly banks—by adopting the American Bar Association amendments.

Hoping that this finds you and Dotty well and looking forward to seeing you in another couple of months, I remain

Affectionately,

JAMES S. BUSH, *Vice President.*

QUAIL & CO.,
Davenport, Iowa, April 14, 1954.

Senator GUY M. GILLETTE,
Senate Office Building,
Washington, D. C.

DEAR SENATOR GILLETTE: The tax revision bill, section 112 (b) (3), has passed the House but contains one provision that is very detrimental to small businesses in that: (1) Previously merging one company into another where holding of the shares continues relatively in the same position, the Bureau has usually declared the transaction tax exempt until the holder sells the shares of the surviving corporation. The new provision requires that the old holders must end up with 25 percent of the surviving corporation.

This means that when it is impossible to sell for cash and a merger is the only way out, the capital gains tax will apply and force a sale of part of the new securities to pay the tax. It will also preclude the progress resulting from a number of the smaller mergers. A merger will practically be a sellout for people who wish to partially retire from management.

It is an arbitrary rule and a very unfair one. I hope you will do your best to have this provision changed.

Very truly yours,

JOHN J. QUAIL.

THE STOCK GROWERS NATIONAL BANK,
Cheyenne, Wyo., April 13, 1954.

Hon. LESTER C. HUNT,
Senate Office Building, Washington, D. C.

DEAR LES: In the new tax bill, which proposes a general overhauling of the income-tax laws, I notice what looked to me to be a rather drastic limitation on investments that could be made in employees' profit-sharing and pension trusts. As I would understand it, the proposed law would limit the investment in any stock or bond of any one issuer, or to any one borrower in the case of a real-estate mortgage, to 5 percent of the total assets of the trust.

I presume that this limitation is put in the law to compel diversificaion of investment of these trust funds and with that I am entirely in sympathy. Diversification is an excellent and fundamental safety measure. The rub comes, though, it seems to me, and it is a very serious one, in applying the 5-percent limitation to the very small employees' trusts, which we would have out in this country where businesses are all small and the trusts set up for their employees' benefit requirements are very small.

We have here at this bank a profit-sharing plan for employees. The bank's contribution each year is put into a trust fund and the contribution probably amounts to about $10,000 per year on the average. It isn't likely that this trust fund would ever build up to much in excess of $50,000, due to the fact that there are withdrawals every year arising from people leaving our employ for one reason and another, and this, of course, gives rise to a payout of their share in the trust fund. The 5-percent limitation even when the fund reaches its maximum of $50,000 would limit our investment in any one stock or bond or mortgage to $2,500. Mortgages to us would be the most profitable outlet for our trust funds and it would be almost impossible to keep any fund continuously employed where the amount of each individual mortgage is limited to so small a sum as $2,500. While the fund is growing our problem is, of course, magnified, since the total trust fund is smaller. At the moment, as I recall, the balance in our fund is $24,000, so that 5-percent limitation pinches us down to $1,200 maximum for any single investment. It think it would be just about impossible to do anything at all in the way of making mortgage investments, for instance, with this limitation upon us.

In the trust department of our bank we also administer funds of several other employees' pension trusts and these, while they were started by good representative businesses in our community that are regarded as major employers, are even smaller than our own employees' trust fund. These people are going to have an even more difficult problem than we have in keeping their funds invested at anything that yields a decent rate due to the difficulty of complying with the 5-percent limitation.

This 5-percent limitation wouldn't present much of a problem to a fairly sizable fund, say, $100,000 or over, but it does work a real hardship and will be a severe handicap on the small funds. Wouldn't it be entirely reasonable to make the limitation read $5,000 or 5 percent, whichever is the larger, or better still, make it $7,500 or 5 percent, whichever is the larger? Such a change would give respectable freedom of movement to the small pension fund and surely could not greatly increase the risk. I think the average small pension fund can do a lot better job investing a good portion of its assets in local real-estate mortgages than it can in buying corporate stocks or bonds. In real-estate mortgages the trust fund managers are dealing with something that they are entirely familiar with, whereas in the stocks or bonds they would necessarily need in most instances to depend upon the advice and recommendation of others.

If you can see your way clear to do so, I would certainly appreciate it if you would use your efforts to diminish the harshness of this 5-percent limitation. In doing so, I am sure you will be rendering a great service to all of the smaller employees' profit-sharing and pension trust funds all over the country.

With kindest regards.

Yours very truly,

F. W. MARBLE, *President.*

MOMSEN & FREEMAN,
New York 5, N. Y., April 9, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the United States Senate,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: I have read with considerable interest the sections of the proposed revision of the Internal Revenue Code (H. R. 8300, 83d Cong.), relating to income derived from foreign sources, and the right to deferment as to income of foreign branches. As attorneys, specializing in the field of international operations, we are especially interested in the provisions of sections 923 and 951. I have a number of suggestions to make with respect to the aforementioned sections, which I believe merit the serious consideration of the Senate Finance Committee.

I. SECTION 923

Under section 923, a tax credit of 27 percent is allowed to domestic corporations as to income derived from sources within a foreign country, either in the form of profits resulting from branch operations, or dividends from a foreign corporation. There appears to be an exclusion from this benefit with respect to such income where import-wholesale and branch sales office operations are carried on in a foreign country, or an office is maintained abroad to facilitate the importation of merchandise.

This exclusion would appear to be discriminatory and unreasonable. Many American firms maintain branches abroad or subsidiary foreign corporations for the purpose of doing business in foreign countries, such operations involving an investment of capital, the importation of goods and merchandise from the United States and their sale to or through wholesalers, jobbers, and distributors. These firms are doing business in the foreign countries, and are subjecting themselves to foreign taxes and all the risks incident to the conduct of a trade or business in a foreign country. The exclusion of this type of operation is unwarranted. The same risks and foreign tax liabilities are assumed as in the case of retail operations, now included in section 923, and furthermore, the import-wholesale and branch sales office operations are most important to the promotion of the foreign trade and commerce of the United States.

It would appear to me that the Senate Finance Committee should consider the following as possible amendments to section 923:

(*a*) Replace section 923 (a) (3) (ii) with the following:

"Has been derived to the extent of at least 90 percent from the active conduct of a trade or business within a foreign country."

(*b*) Eliminate section 923 (b) (1), in view of its restricted character.

II. SECTION 951

The same criticism that I have made with respect to section 923 would apply also to section 951, and since the benefits under section 951 are closely related to section 923, it would be necessary to make a similar change in section 951.

Accordingly, I would suggest the following amendments to section 951:

(*a*) Eliminate from section 951 (a) that part of the paragraph reading as follows:

"Through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country."

(*b*) Eliminate section 951 (b) (1) in view of its restrictive character.

I believe that there is a further case of apparent discrimination with respect to section 951 (c) (2), which excludes from the right to deferment of income, a domestic corporation which claims Western Hemisphere trade corporation status. If a domestic corporation claiming such status is doing business in a foreign country through a registered branch, the income from such branch operation also should be entitled to the right of deferment. In this connection, I believe that section 951 (c) (2) should be eliminated.

The above suggestions are in the interest of American business and in accordance with the intention and desire of the administration to foster foreign trade and investments abroad.

In support of, and as further clarification of the views expressed in this letter, I enclose, herewith, a copy of an article entitled "Serious Defects in Proposed United States Tax Legislation Affecting Income From Overseas Operations," which I have written and which will appear in the April 19 issue of Export Trade and Shipper magazine.

I consider the suggestions I have made to be of vital importance, and if you believe that they should be developed before the entire committee, and you deem my presence advisable, I would be glad to go to Washington to present my views.

Very sincerely yours,

JOSEPH S. CARDINALE.

SERIOUS DEFECTS IN PROPOSED UNITED STATES TAX LEGISLATION AFFECTING INCOME FROM OVERSEAS OPERATIONS

(By Joseph S. Cardinale, attorney and counselor at law, Momsen & Freeman, New York City)

Legislation now pending before Congress revising the Internal Revenue Code proposes the granting of a 27-percent tax credit with respect to income derived from foreign sources, either through a foreign subsidiary corporation or a foreign branch, and the right of deferment as to income of foreign branches. The legislation in question has been approved by the House of Representatives and is now being considered by the Senate Finance Committee.

Undoubtedly there can be no objection to the purpose and general scope of the proposal other than the customary and repeated complaint that the United States Government tax policy with respect to foreign investments does not go as far as is desired and necessary, that is, the elimination of double taxation by recognition of the principle of taxation of foreign income at the source. At best, there is only a partial recognition of this principle in the pending legislation, and, although somewhat limited in scope, nonetheless welcome, for it indicates the continued desire of the Government to extend more favorable tax treatment to income from overseas operations, and it is a step in the right direction.

However, a careful examination of the proposed legislation reveals serious defects which should be brought to the immediate attention of the Senate Finance Committee, and in this connection the active support of American business interests is essential in order that its voice be heard and corrective steps be taken. For this purpose, an analysis of the proposed section 923 (business income from foreign sources and section 951 (income which may be deferred) are presented herewith:

I. SECTION 923

(A) A tax credit of 27 percent of the combined normal and surtax is allowed as to income derived from sources within a foreign country with respect to:

(1) Income from foreign branches of a domestic corporation, when such income is the result of the active conduct of a trade or business, through a

factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business, situated within a foreign country (also see sec. 951 A).

(2) Compensation resulting from the rendition of technical, engineering, scientific, or like services.

(3) Dividends from a foreign corporation—

(*a*) derived at least 95 percent from sources without the United States;

(*b*) derived at least 90 percent from the active conduct of a trade or business, through a factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business, situated in a foreign country; and

(*c*) which does not consist of more than 25 percent of gross income from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States.

(*d*) It is further required that the domestic corporation, either alone or in association with not more than 3 other domestic corporations, own more than 50 percent of the voting stock of the foreign corporation; or

(*e*) that the domestic corporation own not less than 10 percent of the voting stock of the foreign corporation and that the trade or business of such domestic corporation be related to the trade or business of the foreign corporation by reason of the rendition of technical, engineering, scientific, or like services or assistance incident to the trade or business of the foreign corporation.

(4) Interest from a foreign corporation, if, during the year in which such interest is paid, the recipient domestic corporation fulfills one of the requirements set forth in 3 (*d*) and 3 (*e*) above.

(B) In defining the term "trade or business," as used above, section 923 provides that it does not include an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise, or the maintenance of an office or agent, other than a retail establishment, to import or facilitate the importation of goods or merchandise.

(C) Excluded from this particular 27-percent-tax credit are Western Hemisphere trade corporations and other special types of corporations already receiving special tax treatment.

The general principle on which the proposed section premises the 27-percent-tax credit appears to be the maintenance abroad of an establishment or the rendering of services, or investment in a foreign country. Furthermore, the particular tax credit is granted without limitation as to the area of operation or investment, and regardless of whether a registered branch or a foreign subsidiary method of operation is used. In this respect, the proposed section is an improvement on the present section 109 relating to Western Hemisphere trade corporations, in that the benefit is extended to foreign corporations, thus permitting American business to select the form or method of operation desired, as contrasted with the provision of section 109 restricting the benefits only to operations through a domestic corporation, and, consequently, excluding income from a foreign corporation.

However, there is a serious defect in the proposed section 923, which is, in fact, discriminatory and unreasonable, and which should be brought to the attention of the Senate Finance Committee immediately. As presently worded, section 923 specifically excludes "import-wholesale" and "branch sales office" operations, either through a foreign branch or through a foreign corporation. This exclusion is arbitrary and strikes at the very core of the methods of operation available to American firms for doing business in foreign countries.

Numerous American companies have established and will continue to set up operations in foreign countries, either through a registered branch or a foreign corporation, for the purpose of importing or facilitating the importation of goods and merchandise from the United States and their sale within the foreign country, directly or through wholesalers, jobbers, and distributors. For this purpose an office must be maintained in the foreign country, a staff employed, storage facilities set up, and furthermore, capital must be allocated to the foreign branch operation.

The "import-wholesale" and "branch sales office" type of operation are most essential to the fostering and promotion of United States foreign trade and, in addition, it is often a necessary preliminary step to expanded operation and investment in the foreign country. Before substantial investments in overseas

manufacturing facilities can be made, a market must be developed and maintained, and the product well established. These types of operation, either through a registered branch or a foreign corporation, are an essential and vital factor in the trade and investment policy of the United States and should be placed on an equal plane with any other type of operation now covered by the proposed section 923.

In this respect, the "import-wholesale" and "branch sales office" type of operation are of greater importance and more worthy candidates for receiving the 27-percent-tax credit than a foreign retail establishment. The present exclusion in section 923 is discriminatory and without valid reason, and furthermore, is injurious to the foreign trade and investment policy of the United States and should be eliminated immediately.

II. SECTION 951

(A) Income may be deferred in the case of a domestic corporation which operates a branch in a foreign country and is engaged in the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, if such branch has derived:

(1) 95 percent or more of its income from sources without the United States;

(2) 90 percent or more of its income from the active conduct of a trade or business; and

(3) not more than 25 percent of its gross income results from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States.

(B) In defining the term "trade or business," section 951, as in the case of section 923, states that "trade or business" does not include the operation of an establishment engaged principally in the purchase or sale "other than at retail" of goods or merchandise, or the maintenance of an office or agent "other than a retail establishment" to import or facilitate the importation of goods or merchandise.

(C) Excluded from the above right to deferment of income are the Western Hemisphere Trade Corp. and other special types of corporations already receiving special tax treatment under presently existing sections of the Internal Revenue Code.

No reference is made to foreign corporations in section 951, in view of the fact that foreign corporation income is not subject to United States taxes; income therefrom to the American stockholders being taxed only at such time as a dividend is declared and paid by the foreign corporation.

Again, as in the case of section 923, previously discussed, there is a serious defect which is in fact discriminatory and unreasonable. The objection is in connection with the definition of the term "trade or business," which being identical with the provision in section 923, results in an exclusion of the import-wholesale and branch-sales-office type of operation, and consequently, income to a domestic corporation from a foreign branch which engages in or facilitates the importation of goods and merchandise and the sale thereof in the foreign countries, directly or through wholesalers, distributors, and jobbers, is excluded from the right of deferment of income. Apparently, sections 923 and 951 are at least consistent, in that they contain the same definition for the term "trade or business."

The effect is an exclusion which is detrimental to the interests of American business and the foreign trade and investment policy of the Nation. There is, certainly, no objection to including retail establishments, but on the other hand, a stronger case can be made out for extending the benefits to import-wholesale and branch-office-sales operations in that these are essential to the development and expansion of overseas markets and eventually lead to substantial investment abroad. The inclusion of the aforementioned types of operations would be wholly consistent with the apparent purpose of sections 923 and 951, that is, the maintenance of an establishment abroad which involves an investment and the actual conduct of a trade or business in the foreign country.

There is an additional serious defect in section 951 which results in the exclusion of a domestic corporation, which claims Western Hemisphere trade corporation status, from the right to deferment of income from sources within a foreign country. This effect is to permit deferment with respect to income from foreign branch operations in general, but to specifically exclude from this right, income from foreign branches of a Western Hemisphere trade corporation. This exclu-

sion again is arbitrary and injurious to the interests of American firms maintaining branches abroad.

An examination of the report of the Ways and Means Committee of the House of Representatives, approving the revision of the Internal Revenue Code (H. R. 8300) and in particular sections 923 and 951, reveals that the committee has adopted the policy that preferential tax treatment is to be restricted to enterprises engaged in the conduct of a business involving a significant investment or economic activity abroad. These phrases, "significant investment abroad" and "significant economic activity abroad," apparently provide the reason for the exclusion of import-wholesale and branch-sales-office operations from the benefits of sections 923 and 951. Even assuming the reasonableness and logic of this criteria requiring a significant investment abroad or significant economic activity abroad, there still would be no valid reason for excluding the import-wholesale and branch-sales-office types of operation, since undoubtedly a significant investment and economic activity abroad are involved in the form of capital, either allocated to the branch operation or invested in the foreign corporation, maintenance of office space, staff, and storage facilities, etc.

If the basis for granting the benefits of sections 923 and 951 is that set forth in the report of the House Ways and Means Committee, then it is reasonable to take the position that the import-wholesale and branch-sales-office types of operation, whether through a registered branch or a foreign corporation, is entirely consistent with such policy and should be included.

The aforementioned exclusion in sections 923 and 951 are of serious concern to American business interests doing business abroad, and it is urgent that appropriate measures be taken to impress upon the Senate Finance Committee the immediate need for amendment of sections 923 and 951, so as to include import-wholesale and branch-sales-office operations, whether conducted through a branch or a foreign corporation, and at the same time to revise section 951 so as not to exclude domestic corporations, which claim Western Hemisphere trade corporation status, from the right to deferment of income from branches abroad.

THE CLEVELAND CHAMBER OF COMMERCE,
Cleveland, Ohio, April 19, 1954.

To the Members of the Senate Finance Committee.

GENTLEMEN: Enclosed is a copy of a report of our committee on Federal taxation with regard to H. R. 8300, being sent to you with the approval of our board of directors. The report deals with some of the more important provisions of the bill which are of general interest.

Your careful consideration of these recommendations will be appreciated.

Sincerely yours,

CURTIS SMITH, *President.*

SUMMARY OF RECOMMENDATIONS AS TO H. R. 8300, THE CLEVELAND CHAMBER OF COMMERCE

1. Corporate and personal income tax rates should be reduced as soon as revenue considerations permit.
2. Effective dates should not be retroactive.
3. Estimated tax returns by corporations should not be required.
4. Depreciation should be further liberalized.
5. Research and development expenditure election should be permitted for individual projects.
6. Corporate reorganization provisions should not discriminate against small and privately held companies.
7. Penalty tax on preferred stock redemptions should not apply to outstanding issues, and is probably unwise and ineffective.
8. Employees' pension plan provisions are too restrictive, particularly for small businesses.
9. Employees' sick benefit qualifications are too restrictive.
10. Distributions to retired partners should be taxed to them regardless of when received.
11. Mortgage foreclosure provisions should not prevent ordinary loss treatment.
12. Optional valuation for estate tax should not be limited.

13. Dividends received credit should be applied for entire calendar year.
14. Intercorporate dividend tax should be eliminated.
15. Consolidated returns penalty tax should be eliminated, and annual election permitted.
16. Capital losses should be allowable against ordinary income.
17. Interest rate on deficiencies and refunds should be reduced to 4 percent.

To the board of directors of the Cleveland Chamber of Commerce:

H. R. 8300 (the Internal Revenue Code of 1954), recently passed by the House of Representatives and now being considered by the Senate Finance Committee, represents the first major attempt to overhaul, clarify, and simplify the present complex Internal Revenue Code. Such an attempt was a herculean task for the Treasury Department and congressional experts who drafted H. R. 8300. Much of the bill is good and a real improvement over the existing Internal Revenue Code. The very enormity of the job, however, quite naturally resulted in errors of draftsmanship that should be corrected before H. R. 8300 becomes law.

Your committee, in the limited time available to it for study of the bill, has not attempted to compile a list of these technical errors of draftsmanship. We feel certain that these errors will be called to the attention of the Senate Finance Committee by bar association committees and similar organizations, and that they will be corrected. We are, however, deeply concerned with certain substantive changes that should have been made in existing tax laws which have not been provided for in H. R. 8300 and with other substantive changes that have been provided for, which in our opinion are unsound. We call attention to the following:

1. CORPORATE AND PERSONAL INCOME-TAX RATES

H. R. 8300 does away with the reduction in corporate income-tax rates that was scheduled to become effective on April 1, 1954, although it permits the similarly scheduled reduction in personal income tax rates to become effective. We recognize that this was considered necessary because of budget requirements and a laudable desire to minimize deficit financing. We have, however, stated before—and we now repeat—that if the Government would get out of all businesses that should be run by private industry, and if it would sell the more than $30 billion of assets used in such businesses, corporate as well as personal income tax rates could be reduced and the budget could be balanced. Furthermore, reduced tax rates might well stimulate the Nation's economy so as to result in greater revenues rather than less. Certainly corporate tax rates should be reduced as promptly as possible and further reductions in personal income taxes should be made by way of a general reduction of tax rates and not by way of an increase in personal exemptions or similar means of favoring a particular group.

2. EFFECTIVE DATES OF LAW

It has always been the opinion of your committee that tax laws should never be made retroactively effective. Many of the provisions of H. R. 8300 are made effective as of January 1, 1954, and other important provisions are made effective March 1, 1954.

Thus, transactions already completed before taxpayers knew the contents of H. R. 8300 will be affected by its provisions. We believe that this is unfair and that no provisions of the act should be made effective prior to enactment of the law. We also believe that such provisions as those dealing with corporate reorganizations, liquidations, etc., which are made effective March 1, 1954, should not be made effective prior to January 1, 1955. Many transactions were planned and in the process of being carried out when the new bill was made public. Furthermore, to make these complicated changes effective before businessmen have a full opportunity to become acquainted with their operation puts an unwise premium on these businesses and taxpayers which have the benefit of day-to-day highly skilled tax advice. While it may be desirable that certain loophole provisions be made effective prior to January 1, 1955, the desirability of closing loopholes should not override the public importance of making the provisions generally effective only after a fair opportunity for understanding them has been afforded to the great bulk of taxpayers who are not availing themselves of loopholes. Certain of the so-called loophole provisions of the proposed code, aimed to catch a relatively few tax avoiders may, in fact, produce unfortunate tax effects on legitimate transactions where no element of tax avoidance is present. During the period of time prior to the final enactment of this bill it will be difficult and sometimes impossible to plan perfectly proper business transac-

tions unless assurances are given that provisions of the bill will not be retroactive. It is our opinion that public announcement should promptly be made to the effect that the provisions as to corporate reorganizations, liquidations, etc., will not become effective until January 1, 1955.

3. ESTIMATED TAX RETURNS OF CORPORATIONS

H. R. 8300 requires corporations to file an estimated tax return and to prepay a portion of their taxes based on such estimated return. The net result will be to increase the tax payments of many corporations by 10 percent in each of the next 5 years. In our opinion this is most inadvisable. The result will be to reduce working capital of corporations at a time when many corporations are short of working capital because inflation has made it necessary to use more working capital to handle the same physical volume of business. This prepayment provision will certainly result in corporations reducing dividends and thus lessening the Government's tax revenues. It will also certainly result in retarding capital improvements by corporations and thus injuring the economy. The administrative burden of corporations in connection with tax returns is already tremendous and should not be increased by the very impracticable task of attempting to estimate their income and filing estimated returns. The Mills bill, which speeded up the payment of corporate taxes, placed a heavy financial burden on corporations and this burden should not be increased at this time.

4. DEPRECIATION

The provisions of the new bill liberalizing depreciation allowances by increasing the permissible rates of depreciation under the declining-balance method is to be commended. H. R. 8300 limits use of the declining-balance method to assets acquired after January 1, 1954. This section should apply to assets acquired or completed after January 1, 1954, to avoid the necessity of applying two different methods and rates of depreciation to a particular asset. Moreover, the new depreciation provisions are too rigid in that they may force the taxpayer to use either a straight line method of depreciation or a declining balance method. The law should permit the use of any other recognized method consistently followed by the taxpayer even if it might result in depreciation allowances in excess of those allowed under the declining balance method. This committee has consistently recommended the adoption of liberalized depreciation provisions in the tax laws and it is of the opinion that the new law should provide that a taxpayer may recover the full cost of depreciable property free of taxes as rapidly as the taxpayer may choose within specified reasonable limits.

5. RESEARCH AND DEVELOPMENT EXPENDITURES

The new law contains a desirable provision to the effect that a taxpayer may elect to treat research and experimental expenditures as current expenses when incurred or as deferred expenditures that may be charged off over a period of time. This, however, is a blanket election covering all research projects and once the election has been made the taxpayer may not change his method of charging off without securing special permission. We believe that necessary research and experiment would be better encouraged by permitting the taxpayer to make an independent election as to the method of charging off to be used with respect to each individual research project.

6. CORPORATE REORGANIZATIONS

Many of the provisions of the new bill with respect to mergers, consolidations, and other forms of corporate reorganizations are most inadvisable. The proposal to tax the gain on paper profits where the shareholders of a merged corporation do not acquire a stock interest of 20 percent or more in the acquiring corporation is wholly unjustified and will certainly make impossible many legitimate and proper mergers and consolidations in which a large company might take over a considerably smaller company. We see no purpose that is served in thus penalizing small companies. This provision should be eliminated. Additionally, the treatment of a so-called publicly held company in a manner different than that in which a private company is treated seems to be unjustified discrimination. We believe that all companies should be treated alike under the corporate reorganization provisions.

7. PREFERRED STOCK BAIL-OUTS"

The new law attempts to close the alleged "loophole" existing in present law with respect to the issuance of preferred stock dividends which are promptly sold by the recipient and then redeemed by the corporation from the purchaser thereof. It does this by providing a penalty tax of 85 percent against any corporation redeeming such preferred stock within 10 years of its issuance. The provision of the new law which makes it apply to outstanding preferred stock issues by providing that these outstanding issues shall be considered to have been issued on January 1, 1954, should not be enacted. Many perfectly legitimate preferred stock issues have been issued in the past and many of them contain sinking fund and redemption provisions. They were, of course, issued without any knowledge of the proposed penalty tax and involve situations where no element of tax avoidance was ever intended or accomplished. Corporations that made such issues at a time when they were perfectly legal should not now be penalized. Any such penalty tax, if one is enacted, should only apply to preferred stock issued after the enactment of the new law and should apply only where the stock does not replace presently outstanding issues. We further question whether the approach used in the new bill of attacking the "bail-out" problem is either wise or effective.

8. EMPLOYEES' PENSION AND PROFIT-SHARING PLANS

The new bill takes commendable steps toward making the rules applicable to employees' trusts more definite and understandable. However, in so doing the specific rules established may result in unfair discrimination against small businesses. For example, it is likely to be impossible for a small business to put into effect a pension plan for its salaried employees because of the arbitrary percentage definition of the "key employees" who cannot constitute more than 10 percent of the participants. Also, the arbitrary percentage limitations on investments will be unduly burdensome on smaller employees' trusts which cannot as a practical matter wisely diversify as much as is required by the 5 percent limitation. Furthermore, applicability or inapplicability of the new provisions to existing plans is not made sufficiently clear, particularly in the case of minor amendments which may in the future be made in present plans.

9. EMPLOYEES' SICK BENEFITS

Sick benefits paid to employees are treated as nontaxable income if they are paid under a plan which uses insurance. If such benefits are paid by a company that is in effect a self-insurer, the sick benefits are taxable to the employee unless his employer's plan meets certain specific qualifications. We see no justification for this distinction. We believe that legitimate sick benefits should be nontaxable to the employee whether paid under an insured plan or by an employer who is in effect a self-insurer.

10. TAXATION OF RETIRED PARTNERS

The proposed law provides (sec. 736) that continued participation in earnings of the partnership shall be taxed to a retired partner for a period of not more than 5 years, and that such participation thereafter will be taxed to the continuing partners as if such amounts were gifts to the retired partner who would receive them "tax free." We believe the inequity of this provision is obvious. Particularly in professional partnerships—law, medicine, engineering, accounting, and architecture—a partner has no opportunity for building up a continuing business investment represented by property, such as buildings, machinery, inventory, and the products of an established business, and it is, therefore, not uncommon for partners to continue participation in earnings after they retire from the partnership. Such earnings should be taxed to the recipients whenever paid and the tax should not be imposed upon the continuing partners who neither receive nor enjoy the benefit of earnings paid to retired partners.

11. MORTGAGE FORECLOSURES

Section 1035 of H. R. 8300, providing for the deferment of gain or loss in connection with mortgage or collateral loan foreclosures, may be a perfectly advisable amendment of existing law insofar as the ordinary individual is concerned. When, however, section 1035 is read in conjunction with section 1221,

which defines capital assets, it would appear that the new law makes a drastic and inadvisable change in the treatment of losses sustained by banks and other organizations ordinarily engaged in the business of making mortgage loans. Presently banks realize an ordinary loss that is fully deductible in connection with mortgage foreclosures. The new law would result in requiring the bank to treat as a capital asset property bid in at a foreclosure sale and thus, when such property is sold, the bank would secure only a capital loss which would be nondeductible except to the extent of capital gains. We believe this result was not intended. In any event, H. R. 8300 should be changed to make it clear that persons engaging in the business of making secured loans realize ordinary losses in case of the foreclosure of such loans.

12. OPTIONAL VALUATION FOR ESTATE-TAX PURPOSES

Present law gives the estate of a decedent an option in valuing the estate for estate-tax purposes as of the date of death or as of a date 1 year after death. The new law permits this option only if the gross estate of the decedent has diminished in value by 33⅓ percent subsequent to the date of death. This provision of the law should be eliminated and the present option should be permitted to stand. The proposed provision could easily result in no estate whatsoever being left for heirs after payment of debts and estate taxes.

13. DIVIDENDS RECEIVED BY INDIVIDUALS

The credit allowed in section 34 of H. R. 8300 for dividends received by individuals is an advisable start toward elimination of the unfair double taxation of dividends and reducing the present unwise premium of debt financing. The provision, as written, may, however, be difficut to administer. Most taxpayers are admittedly careless and do not keep records showing precisely the dates upon which dividends were received. Instead of treating dividends received after July 31, 1954, differently than those received prior thereto, it might be well to allow a credit of 3 percent for the calendar year 1954, 8 percent for the calendar year 1955, and 10 percent for the calendar year 1956 and thereafter.

14. INTERCORPORATE DIVIDENDS

The new tax bill fails to remove the tax on intercorporate dividends. Prior to 1936 such dividends were not subject to income tax. Since that time multiple taxation has been imposed on dividends paid by one corporation to another. The result is triple taxation: (1) The earnings are taxed to the first corporation; (2) a portion of the same earnings is taxed to the corporation receiving the dividend from the first corporation; and (3) the same earnings are again taxed when distributed to individual stockholders of the second corporation. We believe there is no justification for such multiple taxation.

15. CONSOLIDATED RETURNS

The bill fails to remove the penalty tax on consolidated returns. Affiliated corporations are permitted to file consolidated returns because that results in a fair reflection of corporate income. This being true, there is no justification for imposing a 2-percent penalty against a business which finds it necessary to operate through subsidiaries as compared with one that can be operated as a single corporation. We believe this penalty should be repealed. If, purely for revenue reasons, the penalty must be maintained, it is only fair that affiliated corporations should at least be given the right to make an annual election as to the use of a consolidated return.

16. CAPITAL LOSSES

The bill continues in effect the limit of $1,00 per year for net capital losses of an individual and continues to deny entirely the deduction of net capital losses of corporations. In our opinion, net capital losses are real losses and there is no justification for subjecting net capital gains to taxation on one basis but allowing deduction of net capital losses on a different and very discriminatory basis. Net capital losses should be allowed as deductions, at least to the same extent that net capital gains are subjected to tax.

17. INTEREST RATE ON TAX DEFICIENCIES

The new bill continues in effect the 6-percent rate on tax deficiencies. Under today's conditions this rate is entirely to high. In our opinion, the interest rate on deficiencies should not exceed 4 percent and the interest rate on tax refunds should be similarly reduced.

Respectfully submitted.

E. G. HALTER, *Chairman*,
COMMITTEE ON FEDERAL TAXATION.

STATEMENT OF SENATOR EARLE C. CLEMENTS IN OPPOSITION TO SECTION 274 OF THE PROPOSED REVISION OF THE INTERNAL REVENUE CODE (H. R. 8300)

This is to urge that section 274 be deleted from H. R. 8300, the proposed revision of the Internal Revenue Code. Section 274 would deny tax deductions for rentals paid by manufacturers on property financed by States or municipalities through revenue bonds.

A precedent such as section 274, which invades the complex and controversial subject of Federal State relations in the field of taxation, should be studied at great length. An opportunity for full discussion of this section should be given to the many thousands of municipalities and quasi-governmental corporations who would be adversely affected by its passage.

It is my understanding that this section denying tax deductions for rentals was a last-minute substitution for a more direct attack upon municipal tax exemption. Due to great opposition to a measure which would have hit directly at tax exemption on municipal bonds, the more devious approach of section 274 was substituted.

The attempt to pass legislation in the field of municipal tax exemption through the indirect approach of section 274 is not consistent with the avowed purpose of H. R. 8300. In referring to the proposed revision of the Internal Revenue Code, Secretary Humphrey, of the Treasury, told the Senate Finance Committee on April 7 that this bill, H. R. 8300, "is designed as a reform of the tax structure." Surely the subterfuge of section 274, which prohibits a manufacturer from deducting his rental costs as a legitimate business expense, could not be considered a reform of the tax structure.

Unquestionably, the Federal-State relationship in the field of taxation is a complex one which requires serious research and study before precipitate action is taken. This was the approach taken by Congress and President Eisenhower when the joint congressional and executive Commission on Intergovernmental Relations was set up to work out a solution to the entire problem of Federal-State-local relations.

Adoption of section 274 would prejudge one very important aspect of the study now being conducted, and would be considered by many as an encroachment on the political sovereignty of the States and local governments. Certainly there has not been the extensive publicity and discussion prerequisite to an important and unprecedented step of this kind.

There is not believed to be a precedent for action of the kind proposed in section 274 which would deny a manufacturer the right to deduct a normal business expense such as rent from the earnings upon which he is taxed. It is obviously discriminatory, as municipalities which lease property financed by revenue bonds will have a tremendous handicap in obtaining lessees under such unfavorable terms.

This section cannot be viewed as other than an entering wedge in a long and determined effort by some groups to destroy the constitutional immunity of State and local bonds from Federal taxation.

The effect of municipal revenue bond financing on relocation of industry has been extremely small. Considering the case of Kentucky, it is seen that authority for issuance of revenue bonds for industrial development has been available since 1946. In these 8 years exactly 4 revenue bond issues have been floated, representing a total plant investment of a little over $2 million. This investment as a result of revenue bond financing represents less than two-tenths of 1 percent of the total value of new plants located in Kentucky during this period. It is my understanding that the insignificant value of plant investment in Kentucky through revenue bond financing is comparable to the situation in the several other

States using revenue bonds. However, it is important in those cases where it is used; despite the small amount of industrial investment made as a result of revenue bond financing, its use is extremely valuable in cases where private financing is unavailable to a community suffering from chronic unemployment.

The volume of industry relocated through revenue bond financing has been inconsequential, and the evidence clearly indicates that the effect of these bonds in inducing industries to relocate has been negligible. From a factual standpoint, it is obvious that these bonds have not resulted in any appreciable attraction of industry from other areas.

Nevertheless, the use of such bonds for alleviating economic emergencies is a prerogative of the States which should not be invaded by the Federal Government, either directly or circuitously, as attempted in section 274.

The constitutional immunity from taxation of the Federal and State Governments is reciprocal and should be mutually respected in spirit as well as technicality in order to promote the highest degree of cooperation by and between these sovereign powers. The use of revenue bonds or other devices for developing industry within a State is a problem that can and should be left to the discretion of the State, where the Constitution placed it.

Further indication of the arbitrary and discriminatory character of section 274 is the fact that it singles out revenue bonds as the ultimate target of its attack. There is no economic basis for distinguishing between revenue bonds and those secured by the full faith and credit of the issuing authority. Nor has there been any other rational basis presented for so distinguishing. Unfortunately, the Kentucky Constitution does not permit the issuance of full faith and credit bonds for industrial development. However, it is not suggested that full faith and credit bonds be included within the provisions of section 274. In fact, it is most strongly urged that this devious attempt to frustrate municipal immunity from Federal taxation be entirely deleted from the proposed revision of the Internal Revenue Code.

In further evidence of the alarm with which section 274 is viewed, there is submitted a telegram from the Honorable Lawrence W. Wetherby, Governor of the Commonwealth of Kentucky. This communication clearly indicates the disadvantage resulting to Kentucky from this unjustified attempt of the Federal Government to sit in judgment upon the wisdom of State governmental policies.

It is respectfully urged that section 274 be deleted from the proposed revision of the Internal Revenue Code. Any drastic change in the Federal-State-local relationship would be premature if taken before we have the benefit of the work done by the Congressional and Executive Commission on Intergovernmental Relations.

FRANKFORT, KY., *April 21, 1954.*

Senator EARLE C. CLEMENTS,
United States Senate:

Section 274 of the 1954 revenue revision bill now before the Senate Finance Committee, which would prohibit a manufacturer from deducting rental payments from gross income in cases where a factory building is financed by industrial revenue bonds and leased from a municipality, is a punitive measure unjustly discriminatory and against the interests of our people. While this section is apparently aimed at relocation of established industry, it encourages municipalities to issue general obligation bonds rather than revenue bonds for the construction of factory buildings. However, the lease is not penalized if general obligation bonds are used. Kentucky revised statute 103.200. Which was passed by the general assembly in 1946 authorizes Kentucky municialities to issue revenue bonds for industrial buildings. During this period, over 160 new industries located in Kentucky representing a total investment of over $1 billion, but this statute has not been a major factor in Kentucky's industrial growth and has not been used as a means of luring industry to this State. The authority of this statute has been exercised only 4 times by Kentucky municipalities: In these 4 instances where revenue bonds were issued, the statute served a necessary and important purpose and these industries are now flourishing and providing employment for many hundreds of our people at a time when there is a large amount of unemployment in this State.

LAWRENCE W. WETHERBY,
Governor, Commonwealth of Kentucky.

RICHARDS, HAGA & EBERLE,
Boise, Idaho, April 23, 1954.

Hon. HENRY DWORSHAK,
Senate Office Building, Washington, D. C.

DEAR SENATOR DWORSHAK: We enclose herewith a memorandum we have prepared on sections 272 and 631 of H. R. 8300. These two sections apply to timber; and although adopted to benefit coal owners, these two sections inadvertently penalize timber owners. As you well know, timber is one of the prime industries of Idaho, and we believe that their passage would be a considerable hindrance to the timber industry of Idaho.

Sections 272 and 631 single out timber owners from all other owners of capital assets for discriminatory treatment. The owners of timber are now permitted to deduct from ordinary income all expenses such as taxes, fire prevention, and the like. Sections 272 and 631 would take away the right to deduct a portion of these expenses and would require such expenses to be added to the timber owner's tax basis in determining capital gain. We urge you to support the amendment of H. R. 8300 as set forth in our memo, so as to restore to the code the present provisions of section 117 (k) as they apply to timber.

This is not really a request seeking any special treatment; it is merely asking to preserve the present status of equality with other taxpayers who are afforded the right to deduct all expenses from ordinary income. The need for this equality is emphasized by the fact that timber owners must hold timber for long periods of time, and this change would discriminate against the owners rather than encourage them.

We would appreciate it very much if you would go over this memorandum and either oppose these amendments as such or discuss the matter with the members of the Senate Committee on Finance, who are considering this bill now.

We thank you for your appreciation.

Yours very truly,

W. D. EBERLE.

ANALYSIS OF PROVISIONS OF H. R. 8300 APPLICABLE TO TIMBER OWNERS

1. Description of provisions of H. R. 8300

H. R. 8300 contains provisions designed to afford tax relief to owners of coal (secs. 272 and 631). These sections, which amend section 117 (k) of the present code, relate to timber as well as coal. Although adopted to benefit coal owners, they seriously (and, we believe, inadvertently) penalize timber owners.

Under the present code, persons receiving capital gains are entitled to determine their tax under the so-called alternative computation. Under this computation, the taxpayer may deduct ordinary expenses only from ordinary income. Apparently most coal lessors have no ordinary income, and the amendments to section 117 (k) of the present code were requested to permit these taxpayers to deduct their expenses from capital gains.

Timber owners have ordinary income against which to deduct their ordinary expenses. Consequently, they have never asked for, and do not want, the special-tax treatment desired by the coal lessors. Furthermore, the new provisions discriminate against timber owners in that no other taxpayers are required to deduct ordinary expenses from capital gains.

We believe that the amendments were inadvertently made applicable to timber, and we urge that the provisions of section 117 (k) of the present code relating to timber be restored by the Senate Finance Committee.

2. Background

Timber is unique among natural resources because it is renewable. Throughout the Nation owners of timberland today are engaged in forestry practices that insure another crop of timber in from 30 years in the Southeast to 80 years in the Northwest.

Recognizing the unfairness of taxing in a single year at ordinary rates the income representing from 30 to 80 years of timber-growing effort, and recognizing also the necessity of making it financially possible to grow and hold timber over such long periods, Congress enacted section 117 (k) of the Internal Revenue Code in 1944. Paragraph (1) of that section places the timber owner in the same tax position whether he sells it or cuts it. If he cuts it, he is treated as realizing a capital gain to the extent of the difference between the tax basis of the timber and its fair market value. Paragraph (2) provides like treatment

for timber owners who dispose of timber under a contract providing for payment as the timber is cut, similar to those who sell timber outright (where capital gain treatment has always applied).

In 1951 paragraph (2) of section 117 (k) was amended to cover disposals of coal under a lease providing for payment as the coal is mined. When the paragraph was amended to cover coal additional provisions applicable only to coal were added to paragraph 117 (k) (2) to cover the special problems affecting a resource materially different from timber.

Spurred by the incentive of section 117 (k), and acting in reliance upon it, private forestry has made phenomenal progress during the last decade. The unprecedented investment in forestry and in plants for fuller utilization of our wood supply have brought us to a turning point in the drain of this vital natural resource. As reported by the President's Materials Policy Commission in 1952, the capital gain treatment extended by Congress "has encouraged investment and reinvestment in timber property." The Commission urged that this feature of the Federal tax laws be retained.

3. The provisions of sections 272 and 631 of H. R. 8300 are inconsistent with the purposes of the bill

The Ways and Means Committee report on H. R. 8300 states that the purpose of the changes in the Internal Revenue Code "has been to remove inequities, to end harassment of the taxpayer, and to reduce tax barriers to further expansion of production and employment." We submit that the changed treatment of timber violates each of these three objectives.

First. Sections 272 and 631 as applied to timber create rather than remove an inequity. A timber owner making an outright sale of timber is permitted to deduct from ordinary income the expenses which section 272 of H. R. 8300 requires a timber cutter to add to his tax basis. Thus H. R. 8300 would reestablish the inequity section 117 (k) was designed to eliminate.

Moreover, by denying timber owners the right to deduct their ordinary expenses from ordinary income, H. R. 8300 would single out timber owners from all other taxpayers having capital-gain income. For example:

(*a*) Taxpayers selling property used in trade or business, other than timber, may deduct ordinary expenses such as insurance, fire protection, and taxes from ordinary income;

(*b*) In the sale of mortgaged property or in the sale of securities, items such as interest, taxes, investment counseling services, and the like are deductible from ordinary income.

Secondly. The application of section 272 of H. R. 8300 to timber owners would increase rather than diminish harassment of the taxpayer.

The determination of the holding expenses attributable to the timber cut in any year would be immensely complex and at best would produce an artificial result. For example, it would be difficult, if not impossible, to allocate—

(*a*) Fire protection and insect and disease control costs;

(*b*) General expenses between different species and different stands of timber;

(*c*) Expenses attributable to salvage, prelogging, and felling of snags;

(*d*) Interest on money borrowed by a taxpayer expending funds for timber, land, and manufacturing facilities;

(*e*) Taxes and assessments imposed by or required by State and local agencies for a variety of purposes.

Such allocations would be more than harassment for the hundreds of thousands of small owners—that is, those with less than 5,000 acres each—who own about three-fourths of the Nation's 344 million acres of privately owned forestland.

Finally, H. R. 8300, by denying the right to deduct ordinary expenses from ordinary income, obviously increases rather than reduces tax barriers to further expansion of production and employment.

4. Amendments to H. R. 8300 specifically proposed

Our proposal is simple. We attach as exhibit A a draft of a revision which will:

(*a*) Amend section 272 of H. R. 8300, which is an entirely new provision, so it will apply only to coal;

(*b*) Restore section 631 (a), which relates only to timber, to its present status in section 117 (k) (1) of the code;

(*c*) Separate section 631 (b), applying to both coal and timber, into two sections. The first section will deal with timber and will conform to the language originally adopted in 1944. The second section will deal with coal alone and will be identical with the present language in H. R. 8300.

There are compelling reasons why timber should be treated separately and apart from coal in a tax provision relating to severance, sale, or disposal. In almost every respect, timber involves problems entirely different from coal with respect to management, protection, conservation, severance, and processing—in time, effort, and expense. Throughout its life, which is at least 80 years in the Northwest, timber is exposed to the risk of damage and destruction by animals and insects, by the ravages of winds, floods, and droughts, and by fire caused by both man and the elements. A highly technical tax problem of the kind being dealt with here should not be solved by adopting a single provision responsive to the circumstances peculiar to coal and making such provision applicable to timber. No single provision should be designed to cover both a renewable resource and a depletable deposit.

In requesting the elimination from H. R. 8300 of the new provisions affecting timber, we are not asking for special treatment. We seek only to preserve our status of equality with all other taxpayers, who are accorded the right to deduct expenses from ordinary income. The need of this equality is emphasized by the fact that timber owners must hold timber for a long period of time and by the fact that discrimination against timber owners would penalize, rather than encourage, efforts to conserve a vital natural resource.

EXHIBIT A

PROPOSED AMENDMENT TO SECTIONS 272 AND 631 OF H. R. 8300

SECTION 272. [CUTTING OF TIMBER AND] DISPOSAL OF COAL [OR TIMBER].

[(a) Where the cutting of timber by a taxpayer is considered a sale or exchange under section 631 (a), no deduction shall be allowed for administrative and other expenses, incurred in the taxable year such timber is cut, in connection with the holding and quantity measurement of such timber.]

[(b)] Where the disposal of coal [or timber] by the taxpayer is covered by section 631 [(b)] (c), no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. This subsection shall not apply to any taxable year during which there is no production, or income, under the contract.

SECTION 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. [plus the deductions disallowed under section 272.] Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate.

(b) DISPOSAL OF TIMBER [OR COAL] WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of timber [or coal (including lignite),] held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber [or coal], the difference between the amount realized from the disposal of such timber [or coal] and the adjusted depletion basis thereof [plus the deductions disallowed for the taxable year under section 272] shall be considered as though it were a gain or loss, as the case may be, on the sale

of such timber [or coal]. [Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. In the case of coal, this subsection shall not apply to income realized by any owner as a coadventurer, partner, or principal in the mining of such coal, and the word owner means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, in the case of coal, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determination of the amount of the deduction under section 535 (b) (6) or section 545 (b) (5)).]

[(b)] (c) DISPOSAL OF [TIMBER OR] COAL WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of [timber or] coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such [timber or] coal, the difference between the amount realized from the disposal of such [timber or] coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such [timber or] coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. [In the case of coal,] This subsection shall not apply to income realized by any owner as a coadventurer, partner, or principal in the mining of such coal, and the word owner means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, [in the case of coal,] for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determination of the amount of the deduction under section 535 (b) (6) or section 545 (b) (5).

BASS LAKE COMMUNITY, INC.,
Chardon, Ohio, April 19, 1954.

Hon. THOMAS BURKE,
Senate Office Building, Washington, D. C.

DEAR SENATOR BURKE: It is my understanding that there is a revision to be made in the income-tax law which will be a benefit to Christmas-tree growers We are planting approximately 25,000 trees per year and following the rules and regulations of the Ohio Division of Forestry to help promote conservation in the State of Ohio and we feel that any revision of the tax laws that can be made that will help finance and promote the planting of trees in Ohio should be brought to the attention of our Senators. Since you are from this district of the State I thought it best to ask you if you will use your influence and vote for a reclassication of Christmas trees so they will be considered a timber product.

Yours very truly,

BASS LAKE COMMUNITY, INC.,
CARROLL E. BAZLER, *Manager.*

MOLLIDAY, MILLER, MYERS, STEWART & MCDOWELL,
ATTORNEYS AND COUNSELLORS AT LAW,
Des Moines 9, Iowa, April 20, 1954.

Senator GUY GILLETTE,
United States Senate Building, Washington, D. C.

DEAR SENATOR GILLETTE: I am writing you this letter as legal counsel for the Iowa Pharmaceutical Association which, in convention of its members, asked me to raise objections to a certain provision of the income-tax revision law now before the Senate for consideration.

It is our understanding that there is a provision in the revision of the income-tax deductions for medical expenses to the effect that the cost of medicine and

drugs is to be deducted only to the extent that these items exceed $50 or 1 percent of the adjusted gross income, whichever is greater.

The Iowa Pharmaceutical Association cannot see any justification for such an exception for in the overall picture of medical expenses you have the elements of the doctor's bill, hospital bill, and drugs and medicines, and why one segment of medical services should be pointed out as different from any other is beyond their conception. People have to have drugs and medicines, generally, in connection with medical services and they can see no reason for this unjust classification.

They also want to point out that certainly one of the aims for your bill is for simplification and understanding, and this provision certainly would be one more to present confusion and misunderstanding and chances for errors or oversight. You can ask any person today who has been at the hospital what his hospital bill is and he will give you the total, but seldom does he break it down as to what each particular item consisted of.

Of course, this wouldn't be true as to his purchases at the drugstore, and it seems to the pharmacists that you are just inviting more confusion, more chance for errors, and more misunderstandings, besides being a provision in the bill that is not fair, reasonable, or justified.

The Iowa Pharmaceutical Association earnestly urges you to call this to the attention of the proper people and urges you to use your efforts to have it deleted from the bill.

Thanking you for your cooperation, I am

Respectfully,

I. W. MYERS,
Legal Counsel, Iowa Pharmaceutical Association.

CHAMBER OF COMMERCE,
Walla Walla, Wash., April 19, 1954.

Senator WARREN G. MAGNUSON,
Senate Office Building, Washington, D. C.

DEAR SENATOR: In connection with the current revision of the Internal Revenue Code of 1954, the agriculture committee of the chamber of commerce today adopted a resolution requesting your assistance in securing an amendment of section 60 (a) as an aid to the present complicated schedule of filing times by farmers.

The committee notes that Congress has seen fit to extend the general filing time from March 15 to April 15, and is of the opinion a comparable 1-month extension would be in order for farmers.

It is recognized that a farmer may now make an estimate on January 15 and not file a final return until April 15, but the practical difficulty from a viewpoint of checking records makes it desirable to continue a date closer to the January 15 estimate requirement period. Therefore, it is the suggestion of the committee that the current provision in section 60 (a), Internal Revenue Code, should include a 1-month extension and should therefore be amended as underlined in the following quotation from the code:

"(a) FARMERS.—In the case of an individual whose estimated gross income from farming for the taxable year is at least two-thirds of the total estimated gross income from all sources for the taxable year, in lieu of the time prescribed in section 58 (d), the declaration for the taxable year may be made any time on or before January 15 of the succeeding taxable year; and if such an individual files a return on or before the last day of February of the succeeding taxable year, and pays in full the amount computed on the return as payable, such return shall have the same effect as that prescribed in section 58 (d) (3) in the case of a return filed on or before January 15."

Contacts made by accountants and farmers indicate rather clearly that such a change would meet with favor among agricultural interests, those who prepare the returns for them, and with the Treasury Department, and should, therefore, receive congressional support through the introduction of such an amendment, preferably at the committee level.

This letter is being addressed to you and Senator Jackson, with the thought that the two of you can get together and determine the best procedure to accomplish the recommended result.

Sincerely yours,

ALFRED MCVAY, *Secretary-Manager.*

THE COLUMBIA GAS SYSTEM, INC.,
New York, N. Y., April 23, 1954.

Subject: Revenue bill H. R. 8300, section 1732—Allocation of consolidated taxes.

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

MY DEAR SENATOR MILLIKIN: As is stated in the discussion of consolidated returns, XXIX–D of the report of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8300, the allocation of the consolidated tax takes on added significance because of the lowering of the affiliation test to 80 percent. The allocation of the consolidated tax has unusual significance in the case of utility companies where in the determination of rates some regulatory commissions only allow as a cost the portion of the consolidated tax assessed to the subsidiary company.

Hence, as a matter of equity to minority stockholders, rate payers and investors, an equitable allocation of the consolidated tax is of major importance.

As we understand section 1732 of H. R. 8300, the first and third methods of allocating the consolidated tax do not recognize the carryback or carry-forward provisions of the act that would be available to a company on an individual company basis. The second alternative recognizes these provisions of the act but does not eliminate intercompany dividends in the determination of the tax liability of the individual members of the group.

In the interest of equity in the allocation of the consolidated tax, having in mind the rights of minority stockholders, rate payers, and investors, the second alternative should be amended to provide that dividends from companies within the group shall be eliminated in determining the liability of individual companies, inasmuch as such dividends represent merely a transfer of funds within the group and do not enter into the computation of the consolidated tax.

In order to accomplish this, we submit that the following sentence, or language that would accomplish the same purpose, be added to method (2)—

"In computing each company's tax on a separate return basis, dividends paid by one member of the group to another shall be eliminated."

Respectfully yours,

H. E. OLSON.

PALMER, DODGE, GARDNER & BRADFORD,
Boston, April 15, 1954.

Mrs. ELIZABETH B. SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: Before discovering that you were the person to whom suggestions regarding the new tax law should be sent, I wrote Mr. Colin Stam with my suggestions on the matter. Copies of the letter to Mr. Stam and his reply and my second letter to Mr. Stam are enclosed. I have sent copies to Senators Kennedy, Millikin, and Saltonstall.

Sincerely yours,

JAMES W. PERKINS.

PALMER, DODGE, GARDNER, BICKFORD & BRADFORD,
Boston, April 15, 1954.

COLIN F. STAM, Esq.,
Chief of Staff, Joint Committee on Internal Revenue Taxation,
House Office Building, Washington, D. C.

DEAR MR. STAM: Thank you very much for your letter of April 13.

As to a definition of disability, the definition contained in the proposed section 214 is as satisfactory as that proposed in my letter to you of March 19.

You will recall that I suggested that section 151 (e) (1) (B) of the new law be amended to permit an exemption for dependent disabled children over 18. This would indirectly liberalize section 2, the head-of-family section, and section 213 relating to medical deductions. I pointed out that all these sections discriminated in favor of families with young children or children in college against families with chronically ill children over 18. It seemed especially strange to me that under the proposed law the maximum medical deduction (sec. 213)

was to depend on the number of healthy small children or students in a family but not on the number of chronically ill children over 18.

In view of your reference to section 214, may I suggest as an alternative to my earlier suggestion that section 151 (e) (1) (B) be amended to include the language about disability found in section 214. As so amended, section 151 (e) (1) (B) would read:

"(1) IN GENERAL.—An exemption of $600 for each dependent (as defined in section 152)—

* * * * * * *

"(B) who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student, or (iii) is incapable of self-support because mentally or physically defective throughout at least 6 consecutive calendar months during the calendar year in which the taxable year of the taxpayer begins."

Sincerely yours,

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, April 13, 1954.

Mr. JAMES W. PERKINS,
Palmer, Dodge, Gardner & Radford,
Boston, Mass.

DEAR MR. PERKINS: Your letter of March 19, 1954, analyzes the proposed Internal Revenue Code of 1954 and also notes that no special provision is made for chronically ill children. One of the principal objections to the proposal that special allowance be made for the disabled is the practical problem of defining disability in an administratively feasible fashion.

Present law allows an increased exemption for the blind, a class of disabled persons subject to exact definition, and for persons over 65, since this group may be expected to have increased medical expenses. Section 214 does refer to a "mother whose husband is incapable of self-support because mentally or physically defective," in allowing child-care expenses to certain mothers. Even this provision has been criticized on the floor of the House on the grounds of administrative difficulty.

Under the bill, the parents will have the benefit of the liberalized deduction for medical expenses. Very few persons exceed the maximum limitation on medical expenses, but the lowering from 5 percent to 3 percent for the maximum expenditure that may qualify for the medical deduction will grant relief to many persons who have a dependent subject to chronic illness.

The Senate Finance Committee is presently holding hearings on the bill, and you may arrange to either appear personally or submit a written statement for the record. I may say that there is a lot of sympathy for doing something in this field if a satisfactory definition of total disability can be formulated.

Sincerely yours,

COLIN F. STAM, *Chief of Staff.*

PALMER, DODGE, GARDNER, BICKFORD & BRADFORD,
Boston, March 19, 1954.

COLIN STAM, Esq.,
Executive Secretary, Joint Committee on Internal Revenue Taxation,
Washington, D. C.

DEAR SIR: I would like to point out certain features of the proposed Internal Revenue Code of 1954, as passed by the House of Representatives which to my mind discriminate unfairly against families with chronically ill children over the ages of 19.

Under section 151 (e) (1) (B) of the proposed law, exemptions are allowed for children under 19 and students who have incomes of $600 or more, but not for the chronically ill children over 19 having the same income—despite the fact that the chronically ill cause a far more serious drain on the family finances than a healthy small child or student. This discrimination is not alleviated, but is exaggerated by the medical expense provisions found in section 213 of the new law. There the medical deduction is subjected to several limitations, one of which is that it may not exceed $2,500 multiplied by the number of exemptions allowed (with certain exceptions). Thus, in determining the maximum medical deduction no provision whatever is made for the chronically ill child over 19 whose income equals or exceeds $600, although provision is made for a healthy child under 19 or a healthy student with the same income. To permit the maxi-

mum medical deduction to depend on the number of healthy small children and students in the family but not on the number of chronically ill children over 19 seems anomalous indeed.

No relief is found in the "Head of family" section (S. 2 of the new law). There we find that a widow or widower with a young child or a student having an income of $600 or more is entitled to the "split income" rates, but a widow or widower with a chronically ill child over 19 having the same income pays the full rate. In this respect the new law is less liberal than present law, which allows "Head of household" status regardless of the income of an unmarried dependent child.

As you know, the medical expenses of a chronic illness can be extremely heavy and can last for years and years. Such expenses can easily reduce an otherwise substantial income to an amount insufficient to live on. I am familiar with an instance in which this has happened and continues to happen every year.

The inequities to which I have alluded could be cured in many ways. One way would be to change S. 151 (e) (1) (B) of the new law to read as follows:

"(1) IN GENERAL.—An exemption of $600 for each dependent (as defined in section 152)—

* * * * * * *

> "(B) Who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student, or (iii) is totally or substantially totally disabled from gainful employment, by reason of illness or injury, throughout at least six consecutive calendar months during the calendar year in which the taxable year of the taxpayer begins."

I hope that it is not too late for amendments of this sort to be successfully introduced and would greatly appreciate learning what the possibilities may be.

I am sending copies of this letter to Senators Kennedy and Saltonstall.

Sincerely yours,

JAMES W. PERKINS.

HALE AND DORR.
Boston 9, April 16, 1954.

Re effective date of sections 354 and 359 relative to recognition of gain and loss to corporations in corporate acquisitions and separations, H. R. 8300.

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

(Attention: Mrs. Springer, Clerk, Senate Finance Committee.)

MY DEAR SENATOR: This letter will confirm my telephone conversation today with Mrs. Springer and is to be made a part of the record of the hearings before the Senate Finance Committee in accordance with my understanding with Mrs. Springer.

We represent a group of corporate clients who are in the process of combining with a large corporation pursuant to a plan of statutory merger and consolidation. This transaction is a typical merger on which no gain or loss is recognized under existing provisions of the Internal Revenue Code of 1939 amended to this date.

However, if the provisions of subtitle A, chapter I, subchapter C, sections 354 and 359 of H. R. 8300 were applicable, we believe that gain or loss would be recognized on this merger for the reason that our corporate clients would not qualify as "publicly held" corporations within the meaning of those provisions. I might add that this transaction is a striking example of a merger which is clearly in the public interest; the corporations to be merged operate growing businesses in a new industry in an otherwise generally depressed textile area in Massachusetts, the growth of which have been hampered by lack of adequate financing. The merger will supply adequate working capital and capital for expansion which will be greatly to the benefit of the communities involved both directly in the form of increased employment and indirectly in many other ways. This merger would never have been undertaken if the provisions proposed in H. R. 8300 had been in the law when the transaction was first entered into and it is obvious that such transactions will be, as a practical matter, prohibited in the future if these provisions become law.

We think the proposed provisions are entirely unsound as tending to discourage and prevent transactions of the type presented here and as a discrimination against small business.

However, we feel that we should properly confine this letter to a discussion of the problem of the effective date of sections 354 and 359 (a) if such sections or their counterparts should finally become law. Our case illustrates the problem:

In the latter part of 1953, negotiations commenced for the merger of our corporate clients into a larger "publicly held" corporation. After negotiations, an agreement was entered into between the larger company and the principal stockholders of the smaller companies, the effect of which was that the parties agreed to the basic provisions of the merger and our clients became bound to go through with the transaction subject to the usual conditions subsequent relative to the accuracy of representations, etc. This agreement was executed on February 18, 1954. Under the agreement, the surviving company's liability was contingent upon the approval of a merger agreement by its stockholders at a meeting to be held on April 6, 1954. This meeting was held and the merger was approved. The actual merger is scheduled to be consumated later this month or the first part of May 1954.

It would, of course, be grossly unfair if our clients in this instance were to be affected by a substantial change in the law occurring after they became legally committed. However, under a literal interpretation of section 391 (a) of H. R. 8300, it could be argued that the new provisions would be applicable to this transaction since the actual merger, that is, transfer of property and distribution of the stock will not occur until after March 1, 1954.

We submit that such a fundamental change having such serious tax repercussions should not become effective any earlier than the date of enactment of the legislation and, in any event, should not apply to any transaction where either party became substantially committed prior to such effective date. In fact, having in mind the complexities of the tax structure, the far-reaching changes in H. R. 8300 and the difficulties of the average attorney in keeping up with these matters, it would seem fair that some waiting period should be allowed after the enactment of the law during which time its provisions would presumably have received far greater publicity than a bill which is merely in the legislative gristmill.

Subparagraph 1 of section 391 (a) already provides that part II of the subchapter shall be effective only with respect to distributions made pursuant to a plan of partial or complete liquidation adopted after March 1, 1954. At the very least, this provision should apply to reorganizations and mergers as well as liquidations and therefore part III should be included in this provision. The provision should also make clear that the world "adopted" covers commitments made or incurred prior to the effective date.

We respectfully submit for the consideration of your committee two proposed alternate amendments of section 391 (a) of part VI of subchapter C of H. R. 8300, the first to incorporate a 30-day waiting period which we submit is fair under the circumstances; the second alternative provision would make the law effective as to all transactions which were both initiated and consummated after the passage of the act.

"SECTION 391. EFFECTIVE DATE OF SUBCHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occuring after the expiration of thirty (30) days next subsequent to the date of enactment of this act, except that parts II and III of this subchapter shall be effective only with respect to such distributions or transfers made pursuant to a plan formally or informally adopted, or a liability incurred after the date of enactment of this act."

Alternative provisions:

"SECTION 391. EFFECTIVE DATE OF SUBCHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occurring after the date of enactment of this act, except that parts II and III of this subchapter shall be effective only with respect to such distributions and transfers made pursuant to a plan formally or informally adopted or a liability incurred after the date of such enactment."

I am enclosing four extra copies of each proposed change for your convenience.

I should appreciate acknowledgment of this letter.

Very respectfully,

SAMUEL S. DENNIS 3D.

"SECTION 391. EFFECTIVE DATE OF SUBCHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occurring after the expiration of thirty (30) days next subsequent to the date of enactment of this act, except that parts II and III of this subchapter shall be effective only with respect to such distributions or transfers made pursuant to a plan formally or informally adopted, or a liability incurred after the date of enactment of this act."

Alternative provision:

"SECTION 391. EFFECTIVE DATE OF SUBCHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occurring after the date of enactment of this act, except that parts II and III of this subchapter shall be effective only with respect to such distributions and transfers made pursuant to a plan formally or informally adopted or a liability incurred after the date of such enactment."

UNITED STATES STEEL CORP.,
New York 6, N. Y., April 20, 1954.

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

DEAR SIR: On April 13, Mr. Walter Reuther testified before the Senate Finance Committee and in the course of his testimony attempted to discredit a survey made by United States Steel Corp. of the income and tax facts with respect to its individual stockholders. The results of the survey are set forth in United States Steel's Annual Report for 1953 on pages 22 to 26, inclusive.

In order that your committee may have before it a correct analysis of Mr. Reuther's criticisms, I am enclosing a memorandum dated April 20, 1954, prepared by Bradford B. Smith, economist of United States Steel Corp., together with a copy of the corporation's annual report for 1953.[1]

Since Mr. Reuther's remarks appear in the record of your committee's hearings, we request that this letter and the attached memorandum also be made a part of that record.

Your courtesy in connection with the foregoing will be much appreciated.

Yours very truly,

E. M. VOORHEES.

MEMORANDUM OF UNITED STATES STEEL CORP. IN REPLY TO TESTIMONY OF WALTER P. REUTHER, PRESIDENT, CIO

In appearing before the Senate Finance Committee on April 13 Mr. Walter Reuther sought to discredit the findings of a survey reporting the income and tax facts about United States Steel Corp.'s individual stockholders.

In order that the members of the committee may have the facts before them we would like to file with the committee copies of United States Steel's Annual Report for 1953, on pages 22 to 26 inclusive of which the survey is recorded.

Mr. Reuther listed six points in his attack on the stockholders survey. In the following they are commented upon seriatim.

1. In seeking to impugn the facts set forth in United States Steel's survey of its stockholders Mr. Reuther cites (as disclosed in that survey) that half of the questionnaires sent out were not returned. We are astonished that Mr. Reuther would pretend that the replies received were an inadequate sample. As a matter of fact, a sample based on 50 percent returns—about 140,000 replies—is quite extraordinary. Furthermore—but overlooked by Mr. Reuther—the sampe was proved for representativeness against five unknown characteristics of all individual stockholders. We do not believe that Mr. Reuther really has any serious doubts about the size and proportion of the sample because in this same testimony he cites without condemnation the Federal Reserve Board's "Survey of consumers' finances" for 1952. That survey covered 3,097 consumer spending units, or about one two-hundredth of 1 percent of the 60 million units in the country.

2. Mr. Reuther repeats what the survey announced, that is, that this was a survey of individual, not institutional, stockholders. It did not purport to

[1] Entire report not reprinted in hearings, however, part of it appears on p. 732.

be anything else. Contrary to Mr. Reuther's assertion it did include—and was so stated—those individuals whose stock was in their brokers' names. We did not deem it relevant to either personal incomes or personal tax rates to question insurance companies, industrial companies, schools, churches, hospitals, libraries, foundations, cemeteries, and other institutions on the tax rates to which they were subject. We suspect that Mr. Reuther's bare assertion that these institutions "hold shares chiefly for wealthy people" is more emotional than factual.

3. Mr. Reuther contended that no information was secured from stockholders permitting the distribution of holdings by income brackets below $5,000. This betrays his failure to read the description of statistical methods, appearing on page 26, to which the committee is respectfully referred. Thus, as there indicated, if no tax was levied on the stockholder the top limit of income was established in the case of each type of return: Individual, joint and head of household. Limits of income were similarly established for each tax rate reported. Incomes were thus classified within comparatively narrow control limits. To translate these into the customary $1,000 brackets the patterns of income distribution displayed in the Government's Statistics of Income were used as a model. We are at a loss to know what better or more comprehensive model could be selected. Mr. Reuther did not contest the finding that 8 percent of the stockholders were not subject to any tax and that 56 percent of them had incomes less than $5,000. Mr. Reuther might want us to assume that everybody whose income was less than $5,000 had an income of $4,999.

4. Mr. Reuther charged that incomes of stockholders above $5,000 were understated because of certain assumptions: "That the stockholders (1) were truthfully computing their income tax; (2) understood what tax rate the question referred to (most stockholders are probably painfully aware of their own tax status and would have a more intimate knowledge thereof than Mr. Reuther); (3) had not nontaxable income (the noncoverage of nontaxable income was stated in the report. Such income is irrelevant to the determination of the extent of double taxation of dividends); (4) had no income from capital gains (the survey stated on page 26 that "Income in this study means 'Adjusted gross income'." To the extent that capital gains are considered as and treated as income under the law they are therefore included); and (5) had typical exemptions and deductions (what other assumption could possibly be more appropriate with regard to 140,000 people?)."

5. Mr. Reuther generalizes that "estimate of incomes of those above $5,000 (as opposed to those below) has all the downward biases characteristic of income estimates derived from income tax reports." The incomes of our stockholders were not "derived from income tax reports." As set forth in the description of statistical methods, previously mentioned, those incomes were determined from the income tax rates stockholders reported to us in a manner which did not disclose their individual identities. No self-interest could be served by understating the tax rates.

6. In his last point Mr. Reuther contends that United States Steel's shares are more widely distributed among lower income brackets than all stock holdings. We have no facts on this. If Mr. Reuther has we would be glad to have them. Until then, the United States Steel survey stands as the most comprehensive and representative study of its kind that has ever been made.

BRADFORD B. SMITH, *Economist.*

NEW YORK, N. Y., *April 15, 1954.*

Hon. EUGENE D. MILLIKIN,
Senate Office Building,
Washington, D. C.

DEAR SENATOR: Investors, who supply the so-called equity capital to our corporate industries, since the 1930's have been the object of double taxation on their investments. But they alone have not been the sufferers of this inequity. To pay a tax, the corporation must earn net income. To induce investment for the conduct of its business, it must pay an adequate hiring fee to the investor. All of this has to be collected from its sole source of gain, its customers. The elimination of some of these taxes can benefit the nonstockholder in lower costs to him. At the same time the millions of modest investors, those who take the risks, may receive a fair payment for their risks.

In the conduct of a corporate business the tax laws presently permit as deductibles, before fixing the net for taxing, the cost of doing business, including

cost of material, labor, management, interest on indebtedness, etc. On the net so found, if there be any, is imposed the income tax. From the remaining balance the corporation can or may pay a dividend. This dividend is taxed again in the possession of the equity investor.

Instead of forcing many of the modest investors to use their capital to live, with no resulting tax, the Congress can allow, as a deduction before taxation, the payment by the corporation of a just, limited hiring fee to its equity investors. This hiring fee is not to be considered as profit. It is a necessary cost in the conduct of the business which can exist and grow with equity investment. It would be taxable when received by the equity investor in his tax return. Profit after this deduction can be subject to double taxation.

Thus will equity capital be recognized as important in our economy, and not as a profiteer, and as receiving fair treatment under the laws of our country.

Respectfully submitted.

FREDERICK W. MCGOWAN.

BAKER, HOSTETLER & PATTERSON,
Cleveland, April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building,
Washington, D. C.

MY DEAR SENATOR MILLIKIN: May I respectfully suggest that there are certain gross inequities in the provisions of section 309 of the proposed 1954 Internal Revenue Code as passed by the House of Representatives. This section imposes a penalty tax of 85 percent of the redemption price of preferred stock which has been issued or exchanged in substitution for common, even though such redemption is made through the operation of a compulsory sinking fund entered into years ago and which the corporation is bound to perform. Such tax is to continue for 10 years since 309 (c) provides that a preferred stock issued prior to January 1, 1954, is nevertheless to be considered as having been issued on that date for the purposes of this tax.

If the redeemed preferred had been issued for anything other than common stock of the issuing corporation, then such tax would be only on the excess over 105 percent of the consideration received by the corporation for the preferred (see 309 (a) (3)); but, since common stock of the issuing corporation is expressly excluded from the definition of "property" in section 312, this exclusion of 105 percent is denied for the redemption of preferred which has been issued in substitution for common.

This abolition of exchanging preferred for common stock seems economically unwise and unnecessary to prevent the so-called preferred bailout which has no legitimate corporate benefit or purpose. When applied to preferred stock issued prior to January 1, 1954, it seems not only to be unfair but to be confiscatory; and, if such a statute were enacted by a State, it might well be considered as constituting an impairment of the contractual obligation under the sinking fund.

I believe that the committee has stated that the frequent absorption of small corporations by large ones is economically and socially undesirable. It seems to me that section 309, when coupled with the aforesaid definition of "property" in section 312, stops or prevents a very logical and desirable means of avoiding just such absorptions and prevents many small and closely held corporations from holding young men of ambition.

Many of these closely held corporations are controlled by their founders who are now, because of advanced years, either unable or unwilling to continue their former pace. On the other hand, the younger staff has been trained and is eager to take over and is able to carry on, but these younger men are naturally unwilling to do so if the bulk of their success is to inure to absentee owners or if they are constantly to be in danger of having the control pass on to outsiders or of seeing the corporation become a mere branch plant of a large and distant corporation into which their company is merged. In such a situation the placing of preferred in the hands of the older men and of the common in the hands of the younger men solves the problem in many instances. Such a substitution gives the founders a more assured but limited income and a more salable security in the event of death and a more suitable investment for their estate. On the other hand, the younger management is entitled to the fruits of its effort, acquires control, avoids all of the uncertainties mentioned above and, through

redemption of the preferred, may in the future become the sole owners of the business.

An actual case which I have handled may best illustrate this. Upon securing the client's permission, I will be glad to supply names and all relative data including that with respect to the Commissioner's formal ruling that the transaction was tax free and that the subsequent redemption of the preferred would involve only a capital gain to the shareholder.

A and B had organized an Ohio corporation and had built up a successful and sound business through the years of plain hard work. A died owning 55 percent of the stock, the rest being owned by B. A's widow was his sole heir, a woman of 65 with no business experience. B and his son were unwilling to carry on if the control might pass to strangers or if the 55 percent of the results of their efforts was to go to the widow. They could not buy her stock. On the other hand, the common stock was an undesirable investment for the widow and would be worth very little if competent management was not either continued or procured.

Under these circumstances a recapitalization was effected whereby the widow obtained, in substitution for her common, 2 classes of 5 percent cumulative preferred stock having a par value equal to the value of her common. B acquired all of the common. Both classes of preferred stock were subject to redemption provided that none of class B could be redeemed until all of class A had been redeemed. Class A had no voting rights, but class B had voting rights which gave it control in order that the widow might be protected if through B's death or otherwise the common stock would come into incompetent hands. Each class of preferred contained a sinking fund whereby the corporation was obligated to set aside in each year a percentage of its annual earnings for the redemption of the preferred par. Upon application, the Commissioner ruled formally that the recapitalization was tax free and that the redemption of the preferred stock would result only in capital gain to the holder thereof, even though such redemption was effected through the operation of the sinking fund.

As a result of this transaction the corporation secured a continuity of successful management of which it would have been otherwise deprived and has gone forward very profitably. The widow has an assured, though limited, income and a salable security. B, in turn, has acquired all of the common; and, if he continues to operate the corporation successfully will, within a few years, be able to retire all of the preferred so that he and his son can thereafter be the beneficiaries of the entire earnings produced by their management.

Yet, as I see it, section 309 will, because of the fact above mentioned, require the corporation to pay 85 cents for each $1 paid by it into this preferred sinking fund. I respectfully submit that to impose such a tax upon a transaction entered into years ago for a legitimate business purpose and expressly sanctioned by the Commissioner is, to say the least, unjust. If the recapitalization had been made only for the stockholder's benefit and performed no legitimate corporate purpose such as the typical bailout, I would not object.

Respectfully submitted.

CLAYTON QUINTRELL.

FRED WOLFERMAN, INC.,
Kansas City, Mo., April 17, 1954.

MRS. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MADAM: Reference is made to section 441, H. R. 8300, which is presently under consideration before the Senate Finance Committee. This section enlarges upon the term "fiscal year" to include a 52–53 week period and would permit the filing of income tax returns on that basis.

That the adoption of a 52–53 week year reporting period serves a genuine business purpose has been recognized by Commissioner of Internal Revenue Dunlap in his statement before the Joint Committee on Internal Revenue Taxation on April 4, 1952, and by the recognition accorded by the House Ways and Means Committee in adopting such a provision as section 441 of H. R. 8300. However, section 7851, relating to the effective date of the provision pertaining to the 52- or 53-week year accounting period makes this provision applicable with respect to taxable years beginning after December 31, 1953, and ending after the date of the enactment of the bill. The use of such a date would deny the privilege of adopting a 52- or 53-week year to any taxpayer whose fiscal year ended in 1954 (which in our case is June 30, 1954).

Inasmuch as there has been no change in the tax rates with respect to fiscal years ending in 1954 it is suggested and urged as a practical solution for your committee to amend the bill so that the provision of section 441 will apply either to taxable years ending after December 31, 1953, or, in the alternative, to the due date of returns for fiscal years ending after the date of the enactment of the bill.

The change herein suggested will not result in the loss of any revenue but would permit those corporations and certain industries which for business reasons close their accounting period on a particular day of the week rather than on the last day of the month to immediately elect to adopt the 52–53 week year accounting period.

Very truly yours,

L. CRITCHELOW, *Secretary.*

ARTHUR ANDERSEN & CO.,
ACCOUNTANTS AND AUDITORS,
Seattle 4, April 16, 1954.

Re H. R. 8300, technical changes, section 1223.

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

DEAR SIR: We have noted an unfortunate and perhaps unintended effect involving the application of section 1223 of H. R. 8300 as passed by the House.

This section relates to the holding period for determination of capital gains qualified to take the alternative tax rate, and it prevents tacking on the holding period of a noncapital asset exchanged in a nontaxable transaction to that of another noncapital asset received in the exchange.

Taxpayers in the forest industries find it necessary to work out trades of timber holdings very frequently in order to accomplish the most efficient and economical woods operations through reduction of trucking expenses, road construction costs and related logging costs.

The timber held by taxpayers who are producing operators in the forest industries is not a capital asset; however, the alternative tax is allowed on gains from cutting timber held for 6 months or more prior to the taxable year by the provisions of section 631. It appears that gains from cutting timber received in nontaxable exchanges for other timber during the taxable year or within 6 months of the beginning of the taxable year would, by the above indicated provisions of section 1223, be taxed as ordinary income regardless of the years such taxpayer held the timber given up in the exchange.

Since this effect seems inconsistent we are calling it to your attention so that correction may be proposed if the unfavorable result indicated was not intended.

Very truly yours,

W. L. SCHMATTEBLY.

THE EQUITABLE LIFE ASSURANCE SOCIETY
OF THE UNITED STATES,
Grand Forks, N. Dak., April 17, 1954.

Re H. R. 8300.

ELIZABETH B. SPRINGER,
Senate Office Building,
Washington 25, D. C.

(Attention: Senate Finance Committee—Senator E. D. Millikin, Senator Walter F. George, Senator Harry F. Bird.)

I wish to call your attention to Section 505: Allowable Investments for Employees' Trusts, subsection (a), item No. 3, that denies the trusts right to invest in any life-insurance policy in which the face amount exceeds 100 times the monthly annuity payable at normal retirement age under the plan.

COMMENTS

I can understand why such a denial should be placed on such an investment by the trust if the insured had the right to name his own beneficiary.

But I can see no reason why the trust should not invest in an ordinary life policy if the trust is named as the beneficiary in the policy. This provision

would prevent the insured from deriving any benefit as the result of his death. The other participants in the trust would be the real beneficiaries, whereas if the trust invests in a retirement income policy the insured can designate his own beneficiary.

This limitation would defeat one of the important objectives of an employees' profit-sharing trust.

For example, an employer who wanted to create a trust to make it possible for his faithful employees to acquire ownership of his business by having such a trust purchase or all of his business as time passed and the trust's share of the profits made this possible.

If the trust could not invest some of its funds in a policy on his life with the proceeds payable to the trust in the event of his premature death, the business might be sold or liquidated, etc.

I respectfully suggest that your committee consider adding the following words to item 3, subsection (a) of section 505 "unless the insurance policy names the trust as beneficiary."

This would not create any problem of administration of the law or result in the loss of any taxes and would help some employers to render a real service to his employees, and possibly to his community, by the perpetuation of his business.

Respectfully yours,

C. A. West.

Statement of David Lindquist to be Presented to the Senate Finance Committee Relative to Western Hemisphere Trade Corporations

The writer is David Lindquist, a vice president in charge of exports of the Barry-Wehmiller Machinery Co., and a vice president of its wholly owned subsidiary, the Barry-Wehmiller Export Sales Co. Our company is a manufacturer of made-to-order bottling and processing machinery for dairies, soft-drink factories, breweries, and food-processing plants.

The writer joined this firm as sales engineer in 1937, prior to which he spent 10 years in Latin America. During the 17 years he has been with this company his activities have been restricted to sales of this company's products abroad and until 1947 traveled exclusively, as well as lived, in Latin America.

This company has been singularly successful in the sale of its machinery for export, and especially in Latin America. Our products and name are very well known and widely in use in the industries in those countries. Since business of this kind in this country is a seasonal one with a heavy demand in the fall, wanter, and early spring and a slack season during the summer, our export business, in which the seasons are opposite, enables us to maintain a more even manufacturing rhythm, and, therefore, not necessitating layoffs of labor during slack seasons. Many manufacturers of specialty items and made-to-order goods in this country are subject regularly to these seasonal fluctuations. Export business, therefore, can assist them in maintaining a more even manufacturing tempo with a corresponding benefit to manufacturing labor.

Latin American business, in general, looks to the manufacturers of this country for machinery. There are several basic reasons for this preference for North American machines, the first being that they prefer to pattern their industries along our lines rather than that of the European. A second reason is that deliveries from this country are generally better than from Europe and distances are shorter. A third is the constant fear that another world war could disrupt trade with Europe easier than with the United States and permit purchase of repairs and maintenance parts in this country, should another world conflict again occur. Notwithstanding their preferences for North American equipment, the buyers in those countries are exceedingly price conscious and a much lower machinery cost could outweigh his choice of manufacturer. Further, because of general shortage of dollar exchange, Latin American governments are encouraging purchases with payments spread over long periods.

European competitors now looking for markets for their goods logically look at Latin America. In order to overcome customer preference for North American machines offer lower prices and long credit facilities. European governments to encourage exports offer every assistance to manufacturers, in the form of export subsidies, credit guaranties and exchange insurance. We might cite a news article in the April 12, 1954, issue of Time magazine, Hemisphere Section

illustrating the efforts being made by the German Government to offer credit facilities to Latin American buyers.

We and other manufacturers in this country who find it desirable to do business in Latin America are required to maintain staffs of sales engineers in those countries. Our sales literature, service manuals and the like must be printed in several languages other than English. This is an expensive operation and naturally adds to the cost of doing business.

Since the exporting of machinery and equipment to Latin America is of benefit to North American industry, to the Latin American businessman in furnishing him with modern industrial equipment, and to our Government in helping to maintain good relations with businessmen among our good neighbors to the South, we believe that some assistance should be given to the exporting manufacturer. No credit assistance is available from our Government to make possible long-term payment facilities, nor does our Government have available any exchange insurance, and, therefore, the only available benefit then would be through tax benefits under section 109 to enable him to withstand serious competition.

We do believe that the original intent of section 109 of the Internal Revenue Code relating to Western Hemisphere trade corporations was to offer some encouragement to our manufacturers to do export business in the Western Hemisphere. The arbitrary interpretations of the Treasury Department, however, make it impossible for the small corporations to obtain any benefit from Western Hemisphere business. Their insistence upon literal transfer of title outside of the United States requires the maintenance of branches or warehouses in the country where the equipment is to be used. A small company such as ours finds this entirely beyond the realms of possibility, nor with the type of custom-built machines which we manufacture, is it practical. Further, it makes impossible the usual methods of payment such as letters of credit established in this country by the purchaser, which is the standard of good commerical practice and a method entirely familiar to our customers.

Because of the interpretation of the Bureau of Internal Revenue, our costs of doing business in the Western Hemisphere remain high and we can expect no benefits under section 109, and the competition from other countries becomes even more serious. We look to Congress, therefore, for a clarification of this section which will set forth their purpose in writing the act, so that a Western Hemisphere sale can be defined as one where the equipment, machinery, or product is exported from the United States to a user within the Western Hemisphere without the necessity of the transfer of title outside of this country with the consequent disturbance of usual trade practices. We respectfully urge adoption of such clarifying amendment.

The report of the House Ways and Means Committee, section 921, of the proposed Internal Revenue Code of 1954 states: "Although your committee believes that the present Western Hemisphere trade corporation provisions produce some anomalous results, it has retained those provisions in order to avoid disturbances at the present time to established channels of trade." The admittedly anomalous results, some of which we have outlined above, are already creating disturbances to established channels of trade. They prevent Latin American purchasers from pursuing their normal trade practices in their accustomed manners in order to conform to the stand taken by the Bureau of Internal Revenue.

The clarification amendment of section 109, therefore, will enable many companies in this country to enjoy the benefits of export business to Latin America with the consequent benefit to the people of this country, our Government, and to the peoples of Latin America.

DAVID LINDQUIST.

NEW YORK BOARD OF TRADE,
INTERNATIONAL TRADE SECTION,
New York, N. Y., April 19, 1954.

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

DEAR SENATOR MILLIKIN: The International Trade Section of the New York Board of Trade wishes to place before you and your associates on the Senate Finance Committee, its views on H. R. 8300, hearings on which are now being conducted by the Senate Finance Committee.

The recommendations and the views of our committee on this bill to revise the United States Internal Revenue Code relating to Western Hemisphere trade corporation and extension of benefits to other areas are embodied in the attached resolution.

It is our belief that our views and recommendations are in the great interest of all foreign traders located throughout the country, and on behalf of our members we bespeak for our resolution your earnest consideration and any possible favorable action of your committee thereon.

Sincerely,

FRANCIS X. SCAFURO, *Chairman.*

RESOLUTION

Whereas the Finance Committee of the United States Senate has under consideration legislation (H. R. 8300) revising the Internal Revenue Code of the United States; and

Whereas certain sections of the aforesaid legislation, in particular, sections 923 and 951 are of special concern to firms engaged in foreign trade and in overseas operations; and

Whereas it is believed that sections 923 and 951, as presently worded in H. R. 8300 contain certain exclusions which are discriminatory in nature and detrimental to the foreign trade and investment policies of the Nation, said exclusions, in particular, being the omission of "import-wholesale" and "branch sales office" operations from the 14 point tax benefit provided for in section 923 and from the right to deferment of income as to foreign branch operations, provided for in section 951, as well as the specific omission of Western Hemisphere trade corporations from the right to deferment of income from foreign-branch operations, as provided for in section 951; and

Whereas the International Trade Section of the New York Board of Trade believes that the aforementioned exclusions should be brought to the attention of the Senate Finance Committee, and corrective measures be taken by the aforesaid committee to amend sections 923 and 951 so as to include the types of operations referred to above and now excluded: Be it

Resolved, That the International Trade Section of the New York Board of Trade recommend to the Senate Finance Committee and urge the adoption of the following amendments to sections 923 and 951 contained in legislation now pending before the Congress of the United States and known as H. R. 8300.

(1) Elimination of that part of section 923 (a) (3) A ii reading as follows: "Through a factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business situated."

(2) Elimination of section 923 (b) (1) A and B.

(3) Elimination of that part of section 951 (a) reading as follows: "Through a factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business situated."

(4) Elimination of section 951 (b) (1) A and B.

(5) Elimination of section 951 (c) (2).

STATEMENT OF PEAT, MARWICK, MITCHELL & CO., ST. LOUIS, MO., RELATING TO GAIN OR LOSS FROM SALE OR EXCHANGE OF TREASURY STOCK

According to generally accepted accounting principles, practically all dealings by a corporation in its own capital stock constitute financing or capital-raising activities, as distinguished from ordinary business operations. Such theory does not recognize profit or loss arising upon the sale of treasury stock. From either an accounting or an economic viewpoint, there is no essential difference between (1) the reacquisition and resale by a corporation of its own stock, and (2) the reacquisition and retirement of such stock followed by the subsequent sale of previously unissued stock of the same class. When capital stock is reacquired and retired, any surplus arising therefrom is capital surplus and is so accounted for. The full proceeds of any subsequent issue of stock of the same class also constitutes capital. Surplus arising from the reacquisition of capital stock by an issuing corporation and its subsequent resale is handled in the same manner.

Although the foregoing accounting rules are basic and fundamental and are in accord with the views of the Securities and Exchange Commission, the Treasury Department refuses to abide by them and instead has adopted a

strained construction of the law in an attempt to find taxable income whenever a corporation disposes of shares of its own stock held in its treasury.

Income-tax regulations issued by the Treasury Department in connection with each of the income-tax law enactments starting with the Revenue Act of 1918 down to and including the Revenue Act of 1932 contained the following provision with respect to sales of treasury stock:

"* * * if, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock" (reg. 45, art. 542; reg. 62, 65, 69, art. 543; reg. 74, 77, art. 66).

The early decisions of the Board of Tax Appeals were in accord with these regulations and there was general acceptance of the broad proposition that no gain or loss was realized by a corporation on the sale or purchase of its own stock. By repeated enactments of the provisions of the underlying tax statute, this regulation had acquired the force and effect of law. Despite the long-established rule, the Treasury Department on May 2, 1934, attempted to amend its regulations retroactively. Subsequently the regulation as so amended was adopted as article 22 (a)-16 of regulation 86, the official Treasury Department regulations promulgated as the result of the enactment of the Revenue Act of 1934. Under the regulations as so retroactively amended, the Commissioner of Internal Revenue attempted to tax dispositions of treasury stock occurring prior to May 2, 1934, but the Supreme Court of the United States in *Helvering* v. *R. J. Reynolds Tobacco Company* (306 U. S. 110), definitely ruled that the attempted retroactive amendment was not effective as to transactions occurring prior to the amendment, whereupon the attempt to give the amendment retroactive effect was revoked.

The regulation under the 1934 Revenue Act was not affected by the revocation of the attempted amendment as applicable to earlier years, however, and as adopted in regulation 86 and in all of the regulations issued under subsequent revenue acts and the Internal Revenue Code, this particular regulation has read substantially as follows:

"Regulation 118, paragraph 39.22 (a)-15: Acquisition or disposition by a corporation of its own capital stock. (a) Whether the acquisiton or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

"(b) However, if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."

Since the adoption of the revised regulation set out above in 1934, the Treasury Department has applied an ever-broadening interpretation thereof to cases involving sales of treasury stock in an effort to establish receipt of taxable income. The Commissioner now takes the position that whenever a corporation reacquires its own shares, holds them in its treasury instead of retiring them, and later resells them, it is dealing in its shares as it would in the shares of another corporation and taxable gain results from the transaction. Such an interpretation is not based on congressional mandate. Furthermore, such an interpretation is contrary to the prevailing opinion expressed in the decisions of the Tax Court of the United States. Unfortunately, however, the higher courts to which the Tax Court decisions have been appealed have not agreed with that tribunal but have held, with considerable consistency, that the Commissioner properly found taxable gain to exist.

The Tax Court has examined each case presented on its merits. Thus it has held that no taxable gain was realized when dealings by a corporation were not

carried out with a profit motive but for such reasons as to satisfy a contractual obligation, equalize shareholdings, *Dr. Pepper Bottling Co. of Mississippi* (1 T. C. 80), eliminate a participant wishing to retire, *Brockman Oil Well Cementing Co.* (2 T. C. 168), or implement a profit-sharing plan for employees, *Cluett Peabody & Co.* (3 T. C. 169). In each of these cases the stock was later sold for the purpose of raising traditional capital required in the business. The court held that such results could not be reached by dealing in shares of other corporations. These decisions were not appealed and remain as unreversed law of the Tax Court. More recently in *The Landers Corporation* (1952 memo decision), the Tax Court held similarly with respect to gain on shares resold to provide capital for an expansion and plant refitting program. However, the Commissioner appealed the Landers decision and on Febraury 11, 1954, the Court of Appeals for the Sixth Circuit reversed the Tax Court and held that the gain realized in that case was taxable.

The same reasoning was applied and the same conclusion reached by the Tax Court in three cases involving similar facts, namely, *Rollins Burdick Hunter Co.* (9 T. C. 169), *Batten, Barton Durstine & Osborne, Inc.* (9 T. C. 448) and *H. W Porter & Co.* (14 T. C. 307). In these three cases the Tax Court stressed the fact that the treasury stock, which was sold to employees was restricted in the hands of the employee-stockholders and held that no gain resulted where a restriction existed and there was no change in the taxpayer's capital structure. The Rollins Burdick Hunter decision was reversed by the Court of Appeals for the Seventh Circuit (174 Fed. (2d) 698), the Batten, Barton Durstine & Osborne decision by the second circuit (171 Fed. (2d) 474), and the Porter case by the third circuit (187 Fed. (2d) 939).

Undaunted by these rejections of its views by the higher courts, the Tax Court on February 26, 1954, again held in *The Timken-Detroit Axle Co.*, (21 T. C. No. 85), that no gain was realized where stock which had been acquired through a reorganization was sold to the president of the corporation who agreed to hold it for investment only. The opinion in this latest case decided by the Tax Court referred to the restriction on resale and took note of the contrary opinions on this subject expressed by the second, third, and seventh circuits in the cases referred to above. The Tax Court stated that with due deference to the reversals of its opinion in these other cases, it still felt that its views on this issue were correct and it would continue to follow them. The Timken-Detroit Axle Co. case, if appealed by the Commissioner, will come up for review before the sixth circuit, which is the court that reversed the decision in the Landers Corp. case.

In view of the consistent refusal of the various courts of appeals to agree with the Tax Court on these treasury stock transactions, the situation presently boils down to a demonstrated unwillingness on the part of any court, other than the Tax Court, to treat the sale of treasury stock as a capital transaction in any instance where the sale does not effect a change in the capital structure of the corporation. Since capital structure would seldom, if ever, be affected by the sale of stock held in the treasury, the inevitable result is a uniform holding of taxability with respect to treasury stock transactions.

The trend of the court decisions amply demonstrates that the treatment of treasury stock transactions represents another instance in which the courts have departed from generally accepted accounting principles in their interpretation of the income-tax statutes and their approval of Treasury Department regulations issued thereunder. This variance between income-tax procedures and generally accepted accounting principles is universally deplored and continuing efforts are being made to eliminate such differences. Inasmuch as gain or loss is not and never has been recognized where a corporation reacquires its own stock, cancels it, and subsequently issues previously unissued stock of the same class, it is submitted there is no justification for finding gain or loss to exist where the same stock is reissued rather than new shares. Regardless of the form employed, a corporation's financing and capital-raising activities should not be treated as giving rise to taxable gain or loss.

It is respectfully submitted that legislative action is required to check the broadening interpretation of the Treasury Department in finding a taxable transaction in every sale or exchange of treasury stock. Such legislation should be effective for all open taxable years. Since H. R. 8300, the Revenue Code of 1954, which is presently under consideration by the Senate Finance Committee, does not contain legislation to correct the present unsatisfactory impasse between the Tax Court and the courts of appeal and since the Tax Court is clearly applying the correct accounting principles in its decisions, it is requested that

consideration now be given to the adoption of an amendment to H. R. 8300, which will adopt legislatively the correct rule in such cases.

A suggested draft of a revised section 118 and an entirely new section 276 to be incorporated in the Internal Revenue Code of 1954 by amendment to H. R. 8300 appears below:

"SEC. 118. CONTRIBUTION TO THE CAPITAL OF A CORPORATION.

"(a) GENERAL RULE.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

"(b) GAIN FROM SALE OR EXCHANGE OF TREASURY STOCK.—In the case of a corporation, gross income does not include any gain from sale or exchange of its treasury stock arising from financing or capital-raising activities. As used in this paragraph and in section 276 the term "treasury stock" means shares of the capital stock of a corporation which have been legally issued and thereafter acquired by the corporation but not formally retired.

"(c) CROSS REFERENCE.—For basis of property acquired by a corporation through a contribution to its capital, see section 355.

SEC. 276. LOSS FROM SALE OR EXCHANGE OF TREASURY STOCK.

No deduction shall be allowed upon the sale or exchange by a corporation of its treasury stock arising from financing or capital-raising activities. See section 118 (b) for a definition of the term "treasury stock."

ARTHUR ANDERSEN & Co.,
New York 4, April 20, 1954.

Re H. R. 8300, section 334 (c).

Mrs. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: This is written to bring to the attention of the Senate Finance Committee what I believe are unintended consequences of the allocation required under section 334 (c) after corporate liquidations where under section 331 (c) or (d) no gain or loss is recognized. Under such section the basis of the stock is to be allocated to the assets received in proportion to their fair market values. This results possibly in giving cash balances of the liquidating corporation a basis other than their amount.

Assume a situation where the basis of the assets of the corporation is $100, the basis of the shareholder's investment therein is $110, and the fair market value of the assets is $120. Under section 334 (c) each asset would upon liquidation take an adjusted basis of one hundred and ten one hundred twentieths of its fair market value. Application of this factor to cash on hand, accounts receivable, and other assets with little or no appreciation, would produce the incongruous result of recording cash on hand of the liquidating corporation at less than its amount upon receipt by the shareholder.

To remedy this result, it is suggested that the second sentence of 334 (c) be revised to read somewhat as follows:

"The amount of the adjusted basis of such stock shall be allocated to the various assets received by increasing or decreasing proportionately their adjusted bases in accordance with the differences between such adjusted bases and their respective fair market values."

Your courtesy in bringing this to the attention of the committee at the appropriate time will be appreciated.

Respectfully submitted.

GEORGE J. BRADY.

OBJECTIONS TO PROVISIONS OF PARTS OF SECTION 501 AS SET FORTH IN H. R. 8300—WRITTEN STATEMENT OF HAROLD W. BEYER, C. L. U., ALLENTOWN, PA., AND HARRY A. DOWER, ESQ., OF THE LAW FIRM GETZ, PERKIN & TWINING, ALLENTOWN, PA., FILED ON BEHALF OF HAROLD W. BEYER ASSOCIATES, PENSION CONSULTANTS, ALLENTOWN, PA.

APRIL 21, 1954.

To the Honorable, the Members of the Finance Committee of the Senate of the United States:

We have had a considerable amount of experience in designing and installing pension plans for our clients, who have in nearly all cases been small-business

firms. We have reviewed several sections of the proposed Internal Revenue Code, and desire for the reasons noted below to register our objections to several of its provisions.

Objection is made to section 501 (e) (3) (A), subheading, "Nondiscriminatory Classification." In particular to portions of subparagraph (A), reading as follows:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case, if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and, in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all such regular employees, whichever is greater, are participants in the plan."

The requirement that no more than 10 percent of participants may be key employees, and the 30-percent limitation on contributions for the benefit of participating shareholders, are deemed objectionable.

Also, to section 501 (e) (4) (A), subheading, Ratio of Contributions and Benefits," if—

"(A) in the case of a pension or annuity plan, the contributions or benefits of or on behalf of the employees under the plan do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded;"

The inclusion of "contributions" in the restriction imposed by this paragraph is also deemed objectionable.

Under the Constitution, Congress has the power to levy a tax on income. Inherent in this power is the power to determine or define what is income and to determine pretty largely what deductions shall be allowed in arriving at net income. It is within this framework that the policy of allowing deductions from income for contributions to a qualified pension plan and trust arises. The commendable social policy, adopted by Congress in allowing tax relief to provide for security in old age, resulted in the adoption of present section 23 (p). But it seems to us, in a small close corporation, faced with the proposed 30-percent rule and the 10 percent key employee limitation, that this policy becomes negated. The Government has the problem of raising revenue, and the ostensible policy of the Internal Revenue Code is to raise revenue in such a manner that the tax burden will fall as fairly or equitably upon all persons as can be accomplished, giving effect to what Congress currently considers to be fair and equitable. Raising revenue is one problem, and providing for security upon retirement is another; it is unfortunate that both of these problems have to be dealt with in a revenue-raising measure.

The 30-percent rule and 10-percent limitation ostensibly have been proposed to prevent the payment of contributions to a retirement plan from being a subterfuge for the payment of a dividend. The thought seems to be that, if the money were paid out by the corporation to its shareholders as a dividend, the Government would realize some revenue on this transaction. However, as we shall point out later, we do not believe that there is any net gain or loss in any appreciable amount to the Government regardless of the amount of the contribution for shareholder employees because all of the contribution eventually becomes subject to tax. It may be that the adoption of a retirement plan amounts, in effect, to an interest-free loan to the individual, in the amount of the tax on the money applied to fund the pension, payable in stages on his retirement or in a lump sum at his death. During the period that the individual taxpayer is building up his retirement benefits, he does it at a time when it is most convenient to him to accept this loan and postpone the payment of taxes. It seems to us that this is the real purpose of the congressional policy which developed into section 23 (p) and, viewed in this light, the artificial limitation of the 30 percent rule and the 10 percent key employee limitation seems to be arbitrary, and have nothing to do with either raising revenue or providing for security upon retirement.

We should like to raise the question as to why there should be any restriction whatsoever on the contribution for, or the participation of, shareholder employees. As long as the enterprise is a properly chartered corporation, taxable as such, and as long as the shareholder is a bona fide full-time employee of the corporation, and as long as all the employees of the corporation, or all the

employees in an acceptable classification of the employees, are either covered, or will be covered if they continue in its employment to normal retirement age, we question whether there should be any limitation placed upon benefits or contributions for the shareholder employees, providing there is no discrimination in their favor in any other manner.

The problem principally concerns the close corporation in which there may not be many employees other than shareholder employees or in a certain acceptable classification of employees, especially the salaried classification, in which there may not be many other than shareholder employees.

The thinking concerning security in old age that resulted in the Jenkins-Keogh bill, some variation of which will probably become law in the future, has been approved by both political parties, and by the present administration. Under this proposal an individual, a sole proprietor, or a partner can set up, and get a deduction for, in a private trust or restrictive annuity contract, 10 percent of his income to a maximum of $7,500, with certain allowance over $7,500 and 10 percent for older people. Thus, a partner would be able to do for himself, to the extent of 100 percent of the contribution, what H. R. 8300 would restrict to 30 percent if the partner instead of being a partner were a shareholder in a close corporation. Under the proposed Jenkins-Keogh bill, if the individual is an employee of a corporation, he may not receive the privileges under this proposed legislation if he is eligible to participate in a pension plan of his employer. Under H. R. 8300, a plan for salaried employees of a close corporation, which had union employees who didn't want to negotiate a pension plan, would permit a single shareholder, who was a salaried employee, to participate only up to 30 percent of the total contributions to a salaried trust, or, if there were 5 shareholders who were employees, only 6 percent for each one, on the average; whereas, if the thinking in favor of the Jenkins-Keogh bill, or some variation of it, results in new legislation, and if this corporation were then a partnership, the partners could all put into a private trust or restrictive annuity contract up to 10 percent of their income but not exceeding $7,500, with the increases permitted at older ages. This would represent much more tax-free money and much more so-called abuse than we know of in the most heavily loaded trust for shareholder employees, although under these circumstances, it is called relief not abuse. It seems to us that the Treasury Department is now making a problem out of nothing, providing they agree with the thinking that may produce some legislation similar to the Jenkins-Keogh bill.

Furthermore, as stated before, all this money eventually becomes subject to tax. The distribution under the existing section 165 (b) becomes subject to capital-gains tax at death or whenever it would be accepted in a lump sum; or it becomes ordinary income if accepted as a pension.

The value of the payments from the qualified trust will also be included in the taxable estate subject to the Federal estate tax, and the larger amount of distribution from the trust, which was not taxable when received as ordinary income, will offset the fact that there may be a loss between the ordinary income bracket and the capital gains bracket that is applied at death. That is to say, the capital-gains rate, currently at 25 percent maximum, will probably be less than the ordinary income bracket of the shareholder employee during the years when the contributions were made to the qualified trust. But that means that there is greater value in the trust than there would have been if he received the money in his top tax bracket and accumulated it as ordinary income subject to tax. This difference between the larger value in the trust and the small value that would have accumulated by private investment will all be subject to the top bracket of the Federal estate tax and that should pretty largely offset the difference in the capital-gains bracket and the ordinary income bracket over the years when the contributions were made.

It is probably true that many plans have been set up since the Volckening case eliminated the previous 30 percent rule, primarily for the benefit of shareholder employees, which would not have otherwise been set up. But we know of no case where other employees haven't been carried along for substantial benefits.

A serious effect of the proposed 30 percent rule and 10 percent key-employee limitation is that it discriminates against small business. Executives of large corporations already have pension plans, and the proposed legislation most properly provides that existing plans are not to be affected by the new requirements for qualification. But, even if a large corporation does not now have a pension plan, it can easily adopt one without regard to the 30 percent rule or 10 percent limitation. The managers of the modern, large, publicly held corporation own a very small percentage, if any of the outstanding stock. No difficulty exists in

qualifying a plan for the top salaried executive employees of a large corporation under the number of employee requirements, because a minimum of 100 key employees could be included under almost any classification which management could devise that would not embarrass them before their stockholders. Thus the qualification requirements have no application, in practice, to the large employer.

But small business will be hard hit. (The owners of thousands of sole proprietorships and partnerships are discriminated against now because of the requirement that the pension plan exist for the benefit of employees. It is hoped that they will be afforded some relief under something like the aforementioned Jenkins-Keogh bill.) We are thinking of the small to medium corporate employer. By definition, it has less than 100 key employees. In practice, the shareholders are the keymen. We understand that this is the situation at which the 30 percent rule and 10 percent limitation is aimed; yet the executives in this kind of business have as much, if not more, need for security in old age as the executives of a large corporation and should not lose the opportunity to acquire it simply because they chose to create their own business instead of living their lives as executive employees of a large corporate competitor. It is vital to the American system of free private enterprise that some men so choose to live. This discrimination against the small-business man is, most surely, not in the American tradition.

May we examine a comparison: Assume that a 55-year-old executive of a large corporation receives a salary of $25,000 a year. The pension plan, as established by his employer, provides him with a pension amounting to 25 percent of pay, or $6,250 a year, upon his retirement. This requires a contribution of $8,266.61 as a level annual premium for 10 years to age 65, under a conventional insurance annuity contract. Assume also that this plan is to cover 101 or more key employees. Under the proposed code section, this plan would qualify. Now assume a small corporation, of which the stock is held by three employees, who are also officers, and all of whom are active in the management and production of the corporation. Assume also that they have 4 other salaried employees and 50 hourly paid employees. Assume that the latter are organized into a union, and that the union has bargained for some kind of retirement plan, or in its stead has taken an increase in wages; in any event, the benefit taken did not include the salaried nonunion employees. Assume that a contemplated pension benefit for the salaried employees is also 25 percent of pay and that the salaried stockholder employees are compensated on an average of $20,000 each, and that the 4 other salaried employees receiving an average salary of $5,000 a year. The pensions for the 3 stockholder employees at an average age of 55 would require contributions of $23,808 annually under the same insurance table, and for the other 4 salaried employees the contributions would me $2,328.67,[1] a total of $26,136.61. This is a normal situation, and one frequently found in our practice. Under the 30-percent rule, the contributions for all 3 shareholders would be cut to approximately $1,000 per year (30 percent of $3,328.67=$998) and their pensions reduced from 25 percent of pay to 5 percent or 25 percent, or 1¼ percent of pay, a pension benefit of $0.0125×$20,000=$250 a year. There would be no point in providing such a completely insufficient benefit and the plan would not be pursued. Yet these employees are no different from the executive employees of the large corporation, especially from a human point of view. Either small-business executives can have no pension plan, when the executives of a large corporation can have one, or they must reduce their pension to the degree that the reduction makes the benefits useless.

In view of the tax relief thinking behind the proposed Jenkins-Keogh bill, in view of the benefits that flow to other than shareholder employees, in view of the tax treatment that will apply to the money coming out of the pension trust, in view of the discrimination against small business, in view of the fact that such limitations have no consideration for the actuarial facts, regarding age and salary levels, of providing for retirement, it seems to us that the committee might properly remove all restrictions on contributions for shareholder employees and prepare a code section which will establish acceptable nondiscriminatory classifications and which will eliminate such abuses as appeared in pre-1942 plans in large corporations, covering only a handful of top executives.

We should like to urge the same constructive measure as outlined at the end of the written statement of Bert C. Bentley filed with the Senate Finance Committee as of Wednesday, April 14:

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[1] Average age of 40.

1. That the following language in section 501 (e) (3) (A), to wit:

> "A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification—"

be deleted, and

2. That in the place of the deleted language, there be substituted the following language:

> "Discrimination in favor of employees who are shareholders or key employees shall not be determined by any fixed percentage of contributions or benefits, or both, or by any limitation upon the number or classification of participating employees. A plan—"

We should also like to urge that section 501 (e) (4) (A) be studied to determine whether the inclusion of the word "contributions" in this paragraph may not have the same effect as the 30-percent rule and 10-percent key-employee limitations, and if so, that it be deleted. This section presently reads as follows:

> (4) RATIO OF CONTRIBUTIONS AND BENEFITS.—
>
> (A) in the case of a pension or annuity plan, the contributions or benefits of or on behalf of the employees under the plan do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded.

Respectfully submitted.

HARRY A. DOWER.

INDIANA STATE CHAMBER OF COMMERCE,
Indianapolis 4, Ind., April 24, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington 25, D. C.

MY DEAR SENATOR: On behalf of the Indiana State Chamber of Commerce, we wish to urge the favorable consideration of H. R. 8300, notwithstanding the many defects which have been called to the attention of your committee and which doubtless will be remedied, and any other defects that either cannot be remedied, or will not become apparent until after we have lived with the new law for some time.

This endorsement of the Indiana State Chamber of Commerce was voted at the recent meeting of its board of directors after a report of the Federal finance committee of which I am chairman. Our committee met previously and discussed various phases of the new bill; and three members, in addition to myself, presented a report to the board of directors explaining in detail some of the objectionable provisions of H. R. 8300, as well as some of the reforms hoped to be obtained. The board of directors was unanimous in its authorization to urge the adoption of the new bill, after due consideration by the Senate Finance Committee of the various defects that have been brought to its attention. This action was taken not so much in the belief that a tax millennium would ensue during the next year, or even in coming years, but in the firm belief that 5 years from now, our Federal tax structure will be a better one if built on the proposed new bill instead of consisting of further amendments to the present code. Numerous technical difficulties were noted, such as the many instances in which basis is lost to a taxpayer, and these have been taken up informally with the representatives of the Treasury. But, in addition to these technical defects, there were several policy questions which should be brought to your attention.

1. There was unanimous objection to any requirement that the privilege of merging or consolidating without incurring capital-gains tax be limited to the large publicly held companies as defined in the bill.

2. There was unanimous objection to the requirement that the stockholders of an acquired company own at least 25 percent of the stock of the acquiring corporation after such acquisition.

3. The application of the excise tax on redemption of nonparticipating stock (sec. 309) was felt to be a questionable solution of a most difficult situation, but even if this solution were adopted, it seems unfair to apply the excise tax to presently outstanding issues of preferred stock. The obligation to retire stock

is a contractual one, and it is felt that the situation to be remedied does not require retroactive legislation which would impose an 85 percent tax on the payment of a contractual obligation incurred long prior to the passage of this bill.

4. While the bill allows capital-gain treatment to the stockholder who sells a sufficient portion of his common stock to the corporation so as to qualify for a disproportionate redemption, there is no similar provision with respect to preferred stock. In this respect, preferred stock issued on money or property is at a disadvantage not only with respect to bonds, but also with respect to common stock for, under the present bill, the preferred stockholder owning more than 1 percent of the common stock can never have his preferred stock purchased by the corporation without paying a dividend tax upon a return to him of that which he originally invested in the corporation.

Our board of directors adopted unanimously our recommendation supporting the statement which was submitted to your committee on behalf of the Council of State Chambers of Commerce on April 23, of which council we are members. We do not believe it necessary to repeat that statement herein. It is only fair to add, however, that the bill also contains many provisions which would result in a more equitable determination of taxable income enunciating the principles advocated by accounts for a long period of time.

Among the provisions of particular importance which should be retained in any event are the following sections:

447—Providing for recognition of accepted accounting procedures for computation of income.

452—Relating to accrual of prepaid income.

453—Including much needed rules governing change from accrual to installment basis.

462—Reserves for expenses in conformity with accepted accounting principles.

6072 (a)—Time for filing individual and certain other returns to be April 15 instead of March 15. Subsection 6072 (b) should properly be changed to provide for April 15 as the due date for calendar year corporation returns, particularly in view of the provisions of section 6016 and other sections relating to payment of estimated taxes in advance by corporations.

It is our considered judgment that the benefits to be obtained from the proposed new bill outweigh by far the technical and even policy objections which have been raised in many of its provisions. Taxpayers by the class will benefit immeasurably by the adoption of this new Internal Revenue Code with as many corrections as the Senate Finance Committee is able to make at this time, leaving to the future the correction of other errors and injustices which are inevitable with any bill of this magnitude.

Respectfully submitted.

GEO. S. OLIVE,
Chairman, Federal Finance Committee, Indiana State Chamber of Commerce.

FLORIDA TITLE ASSOCIATION,
St. Petersburg, Fla., April 10, 1954.

Re H. R. 8300—Revised Internal Revenue Code of 1954—Federal tax liens

Hon. SPESSARD L. HOLLAND,
United States Senator, Senate Office Building, Washington, D. C.

DEAR SENATOR HOLLAND: I am advised that a House bill revising the Internal Revenue Code has been passed by the House of Representatives and is now under consideration by the Senate Finance Committee.

May I direct your attention to the provisions of section 6321 of the proposed act, which provides that "the tax shall be a lien in favor of the United States upon all property and rights to property (including the interest of such person as tenant by the entirety) whether real or personal belonging to such person."

I realize that you understand as a former practicing attorney the difficulties which have arisen in a past under the existing provisions of the statute in a situation where the title to a property is held by man and wife and an income-tax lien filed against one of the owners due to the interpretation of the act by the Revenue Department to the effect that the United States has a lien of some sort against the property.

The amended act would make this contention on the part of the Commissioner more certain in some respects: however, the act does not provide to what extent

the claim of lien would exist nor how it is to be enforced nor how it may be released, and we believe that it would vitally affect the method of title evidencing in the State of Florida and would materially and adversely affect the marketability of many titles.

It is the writer's view that if the Federal Government intends to claim a lien under circumstances, the law should specifically provide the extent of the lien, the manner of its enforcement, and the manner of obtaining a release.

Further, I am of the opinion that the act should provide for a waiver of the lien as affecting a bona fide purchaser for value or mortgagee who takes a deed or mortgage from both the husband and wife while that relationship continues to exist and that the tax lien should be relegated to the proceeds of the sale in the hands of the taxpayer as is apparently now the case in situations where there is an inheritance or estate tax and the value of the interest of the deceased spouse in an estate by the entireties has been included in the gross estate for tax return purposes.

I would also like to call to your attention the provisions of section 6323 (3) (b) form of notice, which reads as follows:

"If the notice filed pursuant to subsection (a) (1) is in such form as would be valid if filed with clerk of the United States district court pursuant to subsection (a) (2), such notice shall be valid notwithstanding any law of the State or Territory regarding the form of content of a notice of lien."

Under the existing law of this State as I understand it, this provision would not make any particular difference, but it would appear to me that the Internal Revenue Department should be required to file their notices of lien in the form required by the laws of the different States and Territories, in the same manner as liens of a similar nature are required to be filed.

It is earnestly requested that you give careful consideration to this situation and give the Senate Finance Committee the benefit of your views on the subject.

The St. Petersburg Bar Association, I am advised, last night adopted a resolution requesting that you and Senator Smathers use your best efforts to have these sections amended.

Respectfully yours,

ROBERT V. WORKMAN,
President, Florida Title Association.

STATEMENT IN RE H. R. 8300, SECTIONS 34, 116, 243, AND 246, DEALING WITH CREDITS AND EXCLUSIONS AS TO DIVIDENDS PAID ON STOCKS OF INSURANCE COMPANIES

Statement presented by Harry W. Colmery, special counsel, on behalf of the Farmers & Bankers Life Insurance Co., Wichita, Kans.; the Victory Life Insurance Co., Topeka, Kans.; the National Reserve Life Insurance Co., Sioux Falls, S. Dak., and Topeka, Kans.; the Great American Life Insurance Co., Hutchinson, Kans.; the Pioneer National Life Insurance Co., Topeka, Kans.; the Kansas Farm Life Insuarnce Co., Manhattan, Kans.

1. General statement

H. R. 8300 allows an individual an exclusion of small amounts ($50 to $100) (sec. 116), and, in addition, a credit of a specified percent (5 to 10 percent), of dividends received from domestic corporations (sec. 34); and allows a corporation a deduction of an amount equal to 85 percent of such dividends (sec. 243). However, dividends received from an insurance company are specifically excluded from the exclusion and credit allowance to an individual (sec. 34 (c) (1); sec. 116 (b)), and from the deduction allowance to a corporation (sec. 246 (r) (1)). In other words, as to both individual and corporate taxpayers, all dividends received from an insurance company are taxed, whereas only a part of the dividends received from other domestic corporations are taxed.

In its report (H. Rept. 1337) on the bill the committee said:

"Under present law the earnings of a corporation are taxed twice, once as corporate income and again as individual income when paid out as dividends to shareholders, * * *. This results in a higher tax burden on distributed corporate earnings than on other forms of income. In addition, this has contributed to the impairment of investment incentive. Capital which would otherwise be invested in stocks is driven into channels which involve less risk in

order to escape the penalty of double taxation. This has restricted the ability of companies to raise equity capital through stock issues and has forced them to rely more heavily on borrowed money than is desirable either for the economy or the firm. * * * The penalty on equity financing has been especially harmful to small business which cannot easily borrow funds and must rely on equity capital for growth and survival.

"Your committee has reduced double taxation of corporate dividends by adopting two related provisions * * *" as to individuals (sec. 116 and sec. 34) (pp. 5–6, A. 13–14) (secs. 243, 146) and as to corporations (P. A. 62–63).

The six Kansas life-insurance companies, on whose behalf this statement is presented, are comparatively small in the life-insurance business. They range in assets from $1¾ million to $33¾ million, and, in insurance in force, from $11 million to $147 million. The assets of each of 3 of the 6 are less than $5 million.

They are typical of life-insurance companies in all of the States and the District of Columbia. The 496—approximate—legal reserve life-insurance companies, classify as to assets, as follows:

Under $1,000,000	88
From—	
$1,000,000 to $2,000,000	41
$2,000,000 to $5,000,000	75
$5,000,000 to $10,000,000	60
$10,000,000 to $20,000,000	51
$20,000,000 to $40,000,000	45
Total	360
Above $40,000,000	136
Total	496

It will be observed that 204 or 41 percent have assets of less than $5 million; 264, or 53 percent, have less than $10 million; and 360, or 72 percent, have less than $40 million of assets, the class range of size covered by these Kansas companies. In the 15 States of the Middle West and Rocky Mountain area, 68 of the 80 companies, or 85 percent, fall in this class range. Noting that the States represented by the membership of the Senate Finance Committee present a fairly representative picture from the various areas, we have checked those 13 States and find that 91 of the 114 companies therein, or 80 percent, fall in the class range of the Kansas companies.

The average business life of these Kansas companies is 30 years.

All these companies write business in Kansas. Two write business in Kansas, only; 1 in 1 other State; 1 in 6 other States; 1 in 8 other States; and 1 in 20 other States. They are typical of the companies which, generally, each Senator on the committee will recognize as the local companies in his own State.

Kansas also has several relatively small fire and casualty stock companies whose stockholders are similarly effected by H. R. 8300.

The quotation set forth, hereinabove, from the committee report, No. 1337, shows clearly that the purpose of the committee was to reduce the burden of the double taxation of corporate dividends. With that in mind, the Committee on Ways and Means of the House of Representatives, by excluding dividends received from an insurance company, and taxing them fully, has said, in substance, that:

(*a*) Double taxation on corporate earnings creates an unjust tax burden which should be lessened. We have provided for that relief as to dividends received from all taxpaying, domestic corporations, except insurance companies. Their stockholders, alone, should continue to carry the unjust, higher tax burden.

(*b*) This double tax burden impairs the flow of investment capital needed by business corporations. We have amended the law to lessen that burden and facilitate that flow so as to make investment in corporations more attractive. However, we think that insurance companies should still be saddled with the handicap of double taxation on their earnings, in securing investment capital needed to expand their business.

(*c*) The burden of double taxation is especially harmful to small-business corporations. We want to help them—all of them—except that we do not want to help small insurance companies.

We do not believe that the Congress will want to record in the law such inconsistent and unjust tax treatment.

2. By excluding dividends received from insurance companies from the credit and deduction provisions allowed as to dividends from other corporations, H. R. 8300 discriminates, unjustly and unreasonably, against taxpayers who are stockholders of insurance companies

H. R. 8300 treats the taxpayer who receives dividends from an insurance company, differently than one who receives dividends from a public utility, banking, manufacturing, distributing, or other business corporation. As to the latter, it authorized certain statutory credits and deductions, which reduces his tax: As to the former, it does not allow such credits or deductions, but on the contrary, taxes them fully, grants him no tax relief, and continues the burden of double taxation which the committee states is unjust and as to which it proposed to grant relief.

The committee report states that "Under present law the earnings of a corporation are taxed twice, once as corporate income and again as individual income when paid out as dividends to shareholders" * * * "This results in a higher tax burden on distributed corporate earnings than on other forms of income" * * * "Your committee has reduced double taxation of corporate dividends by adopting two related provisions * * *."

The subject matter of the tax is a dividend received from a corporation. The object or purpose is to reduce the burden of taxation as to such dividends. The taxpayer to whom it is sought to grant relief from that burden is the taxpayer who receives such dividends—he is the one who gets the credit or deduction. As to the present burden of double taxation, his situation is the same, regardless of the nature, type, or kind of the corporation from which he receives the dividend. From whatever the corporate source, he carries the burden of double taxation. His situation and circumstance are the same whether his dividends are received from an insurance company, or any other corporation. Bearing in mind the problem of double taxation, its unjust burden, and the purpose of lessening that burden by allowing the credits and deductions provided in H. R. 8300, there is no natural or substantial difference between a taxpayer who receives a dividend from an insurance company and one who receives a dividend from any other corporation. Consequently, there is no reasonable basis upon which to segregate a shareholder who receives a dividend from an insurance company, out of the general class of shareholders receiving dividends from all corporations, and placing on the former a burden from which all others of the latter have been relieved.

Therefore, in excluding dividends received from insurance companies, H. R. 8300 discriminates unreasonably and unjustly against shareholders who receive such dividends and violates the fundamental principle that taxation must be uniformly applicable to all persons similarly situated.

3. By continuing the burden of double taxation on insurance companies, H. R. 8300 creates a special hardship on and stifles the growth of the small insurance companies

As pointed out in the general statement (1, above), the small Kansas life-insurance companies, on whose behalf this statement is presented, are typical of 72 percent of the life-insurance companies in the United States. It is the shareholder of such small companies against whom the unjust burden of double taxation is continued. This hardship will be particularly detrimental to the companies in the Middle Western and Mountain States, where the life-insurance companies are younger in years, comparatively small, and look forward to expansion and growth to a much greater degree than the older established and larger companies. Comparatively, the need for additional capital is and will be greater. The impairment of the flow of incentive investment capital necessary to meet their requirements for expansion in the years ahead, created by double taxation, will be much more of a handicap to them. Being small, the penalty on equity financing, stated by the committee to be "especially harmful to small business," will place them at a gross disadvantage and retard their growth and development, as against both the competition of the older and larger life-insurance companies, and also the competition for capital as against other corporations whose dividends will have been accorded credits, exclusions, and deductions. It is axiomatic that a prospective investor will not invest money in shares of an insurance company where dividends are fully taxed when he can invest in shares of other corporations whose dividends are only partially taxed.

4. Although the committee report sets forth the reason and basis for limiting the dividend-received credit, the exclusion of dividends from insurance companies does not come within the reason and basis stated; in fact, the committee report does not state why insurance-company dividends are excluded

The committee report states that "the relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations."

An insurance company is neither a foreign corporation nor a tax-exempt domestic corporation. The examples stated (report, pp. 6; A 15–16, A 62–63) are (1) dividends of exempt farm cooperatives; (2) distributions which have been allowed as a deduction to a mutual savings bank, cooperative bank, or building and loan association; and (3) nonresident alien individuals not subject to the regular individual income tax. An insurance company and its taxable shareholder are none of these. On the contrary, H. R. 8300 makes specific provision for the income taxation of life-insurance companies (subchapter L, pt. 1). The exclusion of their dividends, therefore, is contrary to the principle which the committee has stated as the reason for granting dividend-received credit, i. e., relief against double taxation. Insurance companies are still subjected to double taxation, and no reason or explanation therefor is given.

This situation is even more glaringly inconsistent, unjust, and discriminatory as to fire and casualty companies, which are taxed in substantially the same manner as other domestic corporations (subchapter L).

5. A difference of opinion as to the basis upon which life-insurance companies should be taxed does not justify depriving shareholders of life-insurance company stocks of the benefit of the dividend credits, exclusions, and deductions granted to shareholders of other corporations

We understand that a difference of opinion exists as to the basis upon which life-insurance companies should be taxed, and that the House Ways and Means Committee has appointed a special subcommittee to study and review that subject and directed it to report, at the next session, a permanent plan of taxation. In the meantime, (1) such companies are subject to the payment of income tax, and (2) it should be assumed that the subcommittee will recommend a permanent plan of taxation which will represent its best judgment. In the face of these two factors, to discriminate against life-insurance companies and their shareholders is unfair, unjust, and without either legal or moral foundation. The Congress should at least await the recommendations of the special subcommittee, and then decide what the plan of taxation should be. That is a separate subject matter of its own. To permit difference of opinion or prejudice on that matter to create a discrimination against the shareholders of life-insurance companies is beneath the standards of principle and dignity of representatives of the people who should possess and exemplify the patience to be fair and the courage to be just.

6. The discrimination against insurance companies dividends will do irreparable damage to the investment of funds in such companies

The stocks of fire, life, and casualty companies are a normal, recognized field of investment opportunity for those who seek conservative and safe investment of their savings. Returns are not high. But they are considered to be safe and sound. Such stocks are widely held. The shareholder investment is relatively small. They have been favored especially as an investment opportunity by those who primarily seek stability of income and security of principal, such as trust estates.

The committee states that double taxation of corporate earnings "has contributed to the impairment of investment incentive," and that "capital which would otherwise be invested in stocks is driven into channels which involve less risk in order to escape the penalty of double taxation." This discrimination in H. R. 8300 will further compound the situation by driving capital out of stable and safe insurance stocks and into stocks which have less stability, in order to get a reasonable return. The resultant effect will be to impair the flow of investment capital needed to meet the demands for expansion. That will be of irreparable damage to insurance companies, and particularly to the small companies.

CONCLUSION

The holders of insurance stocks are entitled, in equity and good conscience, to the same tax consideration and treatment as are shareholders of other corporate

stocks. They are not aware of the unjust treatment which they receive in H. R. 8300. They will be appalled and indignant when they find out about it, both because of what has been done to them, and the fact that it was done without any notice or opportunity to be heard.

For the reasons stated herein, it is respectfully urged that the section 34 (c) (1), section 116 (b), and section 246 (a) (1), which exclude dividends received from insurance companies from the dividend credit, exclusion and deduction provisions of H. R. 8300 be stricken from the bill.

Statement of Dave L. Cornfeld Relative to Western Hemisphere Trade Corporations

My name is Dave L. Cornfeld. I am a member of the law firm of Salkey & Jones of St. Louis, Mo. We are general counsel for Alvey Conveyor Manufacturing Co. and its wholly owned subsidiary, Alvey Conveyor Export Co. We believe that there is great need for clarification of the present section 109 of the Internal Revenue Code (included in substantially identical form with one minor amendment as sec 921 of H. R. 8300) relating to Western Hemisphere trade corporations, particularly with respect to the effect upon smaller corporations of certain interpretations of that section by the Treasury Department.

The Ways and Means Committee of the House of Representatives in its report on H. R. 8300 has stated:

"Although your committee believes that the present Western Hemisphere trade corporation provisions produce some anomalous results, it has retained those provisions in order to avoid any disturbances at the present time to established channels of trade."

It is our experience that the existing provisions of section 109 as interpreted and administered by the Treasury Department are presently disruptive of established trade channels in certain situations affecting smaller corporations. We would like to submit for your consideration certain clarifying amendments designed to eliminate these difficulties and to restore to smaller corporations attempting to qualify under section 109 the availability of customary trade practices.

The present section 109 of the Internal Revenue Code was added by section 142 of the Revenue Act of 1942 effective with respect to taxable years commencing after December 31, 1941. This section was not contained in the original bill as passed by the House of Representatives but was added in its present form by the Senate Finance Committee. The Internal Revenue Code grants certain tax relief to a domestic corporation which meets the tests set forth in this section, namely:

1. Its entire business must be done in a country or countries in North, Central, or South America or in the West Indies or in Newfoundland.
2. Ninety-five percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or such part of such period during which it was in existence) must be derived from sources other than sources within the United States.
3. Ninety percent or more of its gross income for such period or such part thereof must be derived from the active conduct of a trade or business.

The congressional intent in granting relief to corporations meeting these tests was set forth in the Senate Finance Committee report accompanying the Revenue Act of 1942 as follows:

"American companies 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."

Implicit in the enactment of this section and in the stated intent as expressed in the Senate Finance Committee report is the intention of Congress to stimulate and encourage trade between the United States and other Western Hemisphere countries as an implementation of the good neighbor policy.

Since section 109 as enacted did not contain any special definitions, particularly with reference to the source of gross income, the Treasury Department in its regulations has taken the position that the source of income for the purpose of section 109 in all situations is to be determined as provided by section 119

and the regulations prescribed thereunder. Although the rules set forth in section 119 and the regulations thereunder are in most instances consistent with the intent of Congress in enacting section 109, in certain situations the rules laid down by section 119 and the regulations thereunder may prevent qualification as Western Hemisphere trade corporations of corporations which nevertheless fall within the group which Congress intended to assist.

Section 119 provides that income derived from the purchase and sale of personal property shall be treated as derived entirely from sources within the country in which sold (except in cases where the personal property was purchased within a possession of the United States). The regulation thereunder states: "The 'country in which sold' ordinarily means the place where the property is marketed." If these regulations were interpreted so as to treat the place of ultimate use and consumption as the place of marketing, where it is clear that the property is being sold for use or consumption in a particular locality, such an interpretation would be consistent with the intention of Congress in section 109. However, the Commissioner of Internal Revenue has adopted the position that the source of income in such cases is the place where title to the sold property passes from the seller to the buyer. This position is stated in G. C. M. 25131, as follows:

"In view of the foregoing, this office adopts the general rule that, for the purpose of determining the source of income attributable to the sale of personal property, a sale is consummated at the place where the seller surrenders all his right, title, and interest to the buyer. In cases in which the bare legal title is retained by the seller, the sale will be deemed to have occurred at the time and place of the passage to the buyer of the beneficial ownership and the risk of loss. (See *Ronrico Corporation* v. *Commissioner*, *supra*). However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. (See *Kaspare Cohn, Inc.*, v. *Commissioner* (35 B. T. A. 646)). In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred."

Consistent with this latter interpretation, a United States trading company, in order to qualify as a Western Hemisphere trade corporation, must conduct itself so that title to all (or at least 95 percent) of its merchandise sold passes outside the United States, even though the place where title passes has no effect upon or relation to its competitive position with that of foreign corporations. Such requirement prevents the utilization of many customary trade practices developed over the years as designed to facilitate trade between the United States and other Western Hemisphere countries and makes it particularly difficult for small- and medium-sized companies to avail themselves of the Western Hemisphere trade provisions.

Large corporations which can maintain warehouses, branch offices, or local representatives in the various Western Hemisphere ports to accept shipments and transfer title in the foreign country find little difficulty in complying with the technical requirements of section 119 as applied to section 109. Smaller companies without these resources, and companies which desire to enter the field of Western Hemisphere export trade, and which as much, if not more, need tax relief to meet foreign competition, find that they must incur disproportionate expense in following the methods of larger corporations or, if other methods are used, forego the benefits of standard export practices designed to avoid shipment and credit risks. In many instances the requirement that title must pass outside of the United States places an additional obstacle in the path of Western Hemisphere trade and actually places United States companies attempting to qualify under section 109 at a competitive disadvantage with foreign corporations, since the foreign corporations can continue to do business with the Western Hemisphere customers by familiar methods.

The experience of Alvey Conveyor Manufacturing Co. and Alvey Conveyor Export Co., we believe, is typical. Alvey Conveyor Manufacturing Co. has been engaged in the manufacture of conveying machinery since 1913. The corporation has approximately 225 employees. In most instances its product is made to order, although it does manufacture some standard conveyors, and each conveyor system is intended for installation in a specific industrial plant.

During World War II, as was true of most American manufacturers, the entire facilities of Alvey Conveyor Manufacturing Co. were devoted to war production. Immediately following World War II the company operated at capacity, filling

domestic civilian orders. The management, however, believing that it would be desirable to expand the company's markets, explored the possibilities of making sales in South and Central America, and a sales representative was sent to investigate the potential market in South and Central America. In investigating the export market, the provisions of section 109 of the Internal Revenue Code relating to Western Hemisphere trade corporations afforded an opportunity of engaging in such commerce by helping meet foreign competition.

To meet all of the required conditions of section 109, the company, in line with what had been done by scores of other corporations, formed a subsidiary, Alvey Conveyor Export Co., to meet all of the conditions of section 109. The Commissioner of Internal Revenue, in I. T. 3757, had already ruled, under the policy in vogue at that time, that the formation of such a subsidiary for the express purpose of qualifying as a Western Hemisphere trade corporation would be recognized as valid for tax purposes, in view of the congressional intent of encouraging export trade.

In view of the state of the law, and since there had been no direct court decisions to clarify section 109, it was necessary, under the Commissioner's interpretation of section 109, that the company establish operating procedures so that title to the conveying machinery would pass outside of the United States. Under the general law of sales, the place where title passes is a matter to be governed by contract between the parties to a sale.

Many of the legal writers, in the absence of court decisions, had indicated that in order to be safe, a Western Hemisphere trade corporation should do more than provide contractually for the passage of title outside of the United States. Some legal writers had gone so far as to indicate that a Western Hemisphere trade corporation should maintain either a warehouse or branch office in South America to which the property could be shipped and where possession and title could be transferred to the purchaser. However, the expense of establishing and maintaining such warehouses or branch offices, particularly during the early years of the establishment of South American trade would have been prohibitive for Alvey Conveyor Export Co., as for most smaller corporations. In addition, since most of the conveyor systems sold by Alvey Conveyor Export Co. were made to order, warehousing was totally impractical. The possibility of obtaining agents in South America to whom shipment could be made and who would transfer title was investigated and again it was determined that this expense and complication could not be justified from a sound business or competitive standpoint. It was also obvious that the intervention of a branch office, warehouse. or agent would contribute nothing toward furthering the congressional purpose in enacting section 109 and would merely add complication and expense. The ultimate transaction in any event would be a sale by Alvey Conveyor Export Co., solicited and negotiated in South America to a South American customer of conveying machinery especially designed and constructed for use in a specific South American factory. Alvey Conveyor Export Co. would be competing with foreign manufacturers of conveying machinery for the business of this customer. It would therefore appear logical that the simplest, least expensive means of transporting the property to its ultimate destination would be most desirable to effectate the congressional purpose of section 109.

Nevertheless, the usual and well-established export procedures were not available since it was legally necessary for the export company to retain title until the conveying machinery arrived in South America whereas, under normal practices, title is transferred as soon as possible.

In an effort to comply, the company attempted to work out a cumbersome letter of credit procedure under which an irrevocable letter of credit would be established at a United States bank by the purchaser through a South American bank. The shipping documents would be sent to the South American bank. When the South American bank received notice of the arrival of the shipment, it would turn over the bill of lading to the purchaser and notify the United States bank which would then release payment to the seller. This plan met with objections by our customers on various grounds. It was a new method of doing business and the customers could not understand the reason for changing established methods. They objected to the expense of opening a letter of credit, especially on such terms, since the expense was substantial in South America. In some instances these customers, who were among the leading corporations in South America, considered a request for a letter of credit a reflection on their credit. In a few instances, these customers even offered to pay in advance rather than establish a letter of credit. This created an anomalous situation. In effect, the

company had to say to the customer: "In order to qualify under our tax laws for certain benefits which Congress has conferred in order to encourage and assist us to sell our product to you, we must refuse to do business in the manner you prefer—we cannot accept payment in advance or follow well established trade practices—we cannot pass title to you in our home country as our European competitor can in his—we must insist that you wait until our product arrives in South America to make full payment and to accept title because if we do business as you prefer, we lose the tax benefit which helps us to make a competitive price."

As a result of customer resistance the letter of credit method had to be virtually abandoned. Fortunately, since the customers of Alvey were in practically all instances the outstanding businesses of South America, no credit risk problem existed. However, it can readily be seen that where United States companies do deal with customers which are not of such high caliber, the normal trade practice of having payment made and title pass to the customer prior to shipment would do much to facilitate trade.

Alvey Conveyor Export Co. therefore found it necessary to rely upon the law of sales that title passes according to the intent of the parties. By contract with its customers, it was agreed that title would not pass and that Alvey would bear the risk of damage or loss until the shipment arrived in South America. Even this seemingly simple method has met with some customer resistance, and in certain instances where customers have refused to agree to such passage of title, the sale could not be made by the export company since its qualification would be jeopardized.

Delaying the passage of title raises many problems in dealing with South American customers. In some countries dollar exchange, although available to purchase United States merchandise, is not available for services such as transportation or insurance. In such a case, shipment must be made through a steamship line and the shipment insured with an insurance company which will accept the funds of the buyer's country in payment. In that latter case, the insurance policy will naturally provide for payment in similar funds in the event of loss. Just as naturally, the United States seller will strongly prefer to be insured in United States dollars rather than in some blocked foreign currency. Transactions with buyers located in such countries can be greatly facilitated if the buyer or the buyer's agent can take title in the United States so that he can arrange for the shipment in his own name and insurance can be obtained by the buyer insuring his own interest. In such cases where passage of title and consequent risk of loss or damage is postponed, as a prerequisite to qualify under the provisions of section 109, the seller has the unhappy alternatives of being insured in blocked or restricted foreign currency, or insuring in this country and absorbing the premium cost, or of being a self-insurer. None of these alternatives contribute anything toward the achievement of the objectives of section 109, which was enacted for the purpose of enabling United States companies to meet foreign competition through lowered costs.

Another problem which has arisen because of the passage of title test results from the fact that many South American countries prefer to utilize purchasing agents in the United States for the purpose of placing orders and supervising shipments, even though all preliminary negotiations are carried on in South America. Some of these purchasing agents are wholly owned United States subsidiaries, others are independent contractors on retainer or commission. Under this long-established procedure the purchasing agent is nominal purchaser under the contract of sale, although the contract may show that the agent is acting on behalf of a South American principal. This permits the purchasing agent, a United States corporation, to bring legal action on the contract if such were necessary. The usual form of such transaction is for the purchasing agent to take title to the merchandise in its name in the United States, facilitating consolidation of shipments and the handling of insurance under the purchasing agent's blanket policy and permitting inspection prior to arrival of the shipment in South America. Where these agents are utilized, objections have been frequently raised by Alvey's customers to postponement of passage of title, as altering the established office routines of the agents, creating insurance problems, as well as permit and license problems which are not encountered under the normal procedures to which the buyers have become accustomed.

In addition, even though the merchandise is shipped to South America and title passes there; even though the merchandise is especially designed for use and consumption in South America; and even though the order was solicited

and the negotiations carried on in South America, the revenue agent on audit of the export company's tax return has asserted that if the nominal customer is a United States corporation, the income from such sale should be treated as derived from sources within the United States.

In view of these practical problems and obstacles, of particular concern to smaller corporations, arising out of the "passage of title" test engrafted onto section 109, it is respectfully suggested that section 109 should be clarified so as to carry out the original congressional intent. Obviously, the place of passage of title has no legal, economic, or practical effect upon the need of United States corporations for the elimination of competitive disadvantages with respect to foreign corporations. The place which is the real source of the income and which, in economic fact, determines whether a United States corporation needs tax relief to aid it in competing with foreign corporations, is the place where the merchandise is intended to be used or consumed, that is, the ultimate destination of the merchandise. The price which a customer is willing to pay depends upon what it will cost him to obtain competing products at the place where he ultimately expects to use or consume the product. Except to the extent that legal or administrative difficulties are created, he cares little whether title passes in New York, Rio de Janeiro, or Bogotá, since the net cost to the customer will be the same; namely, the cost of the merchandise at its source (which of course reflects tax costs) plus the cost of transporting it to its ultimate destination. It makes no difference if the cost of transportation is initially paid by the seller and added to the selling price or if it is omitted from the price and paid by the buyer. Even the legal distinction of risk of loss is illusory, since in practically all instances the risk will be covered by insurance, the premium for which will be either borne directly by the buyer or paid by the seller and added to the price. It is, however, the legal and administrative difficulties raised by postponement of passage of title in export situations which causes the serious problem we have.

Based on our experience with section 109 as presently written and as presently interpreted and administered by the Treasury Department, we believe that section 109 should be amended to include an express definition of the "source of income" from export sales which will be consistent with the congressional policy in enacting section 109.

One such possible addition to the section might read as follows:

"The sources of gross income shall, in general, be determined in accordance with the provisions of section 119: *Provided, however*, That, for the purposes of this section, where personal property is purchased within the United States and sold for use or consumption in and actually shipped in due course to another country, the income from such transaction shall be treated as derived entirely from sources other than sources within the United States."

The test suggested by the proposed addition would conform section 109 to the true congressional purpose. The place where the merchandise is intended to be used and consumed would be treated for purposes of this section, as the source of the income arising from the sale, since it is that place which is the real source of the income and which, in economic fact, determines whether a United States corporation needs tax relief to eliminate competitive disadvantages with respect to foreign competing corporations. The provisions of the proposed addition are analogous to the provisions exempting goods sold for export from excise taxes.

An alternative possible addition to section 109, using a somewhat different form of test, could be the following:

"The sources of gross income shall, in general, be determined in accordance with the provisions of section 119: *Provided, however*, That, for the purposes of this section, income from the sale of personal property purchased within the United States shall not be treated as derived from sources within the United States if it is established that the destination of such personal property was outside of the United States."

Such an amendment would place the burden on the taxpayer of providing the ultimate destination. This burden could be met by bona fide exporters through affidavits, the sales contracts, and the shipping documents. The test of destination is as susceptible to easy audit by the Government, if not more so, on the basis of an examination of the sales contracts and shipping documents, as is the passage of title test.

Either of the foregoing tests would eliminate any possible abuse of the Western Hemisphere trade provisions by transshipment to countries outside the Western Hemisphere after passage of title in a Western Hemisphere country, since, if the ultimate destination of the property were outside of the Western Hemisphere,

the income would not qualify. Because of the stringent 95 percent requirement, such amendment could not prove a windfall in the case of corporations making incidental export sales, but could apply only to corporations actively engaged in seeking Western Hemisphere export trade. Also, because of the 95 percent requirement, if such an amendment were made effective with respect to prior years, it could only apply to corporations which have been actively attempting to qualify as Western Hemisphere trade corporations.

The proposed clarifying amendments could in no way disturb established trade channels and would eliminate at least in part the anomalous results referred to by the House Ways and Means Committee and the present inequitable situation which affects small and medium size corporations adversely.

We believe that the proposed amendments would serve as an inducement to more domestic corporations to engage in trade with South America, particularly smaller companies which find qualification as Western Hemisphere trade corporations, at present, impractical. We further believe this stimulus would have a long-range tendency to cause American business to expand and enter into the commercial life of overseas communities.

For the reasons stated, this committee is respectfully urged to give serious consideration to the adoption of a clarifying amendment to section 109, of the type suggested.

EAGLE PUBLISHING COMPANY,
Pittsfield, Mass., April 19, 1954.

Re H. R. 8300 Personal
ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: For many years I have felt the most abused privilege is the personal dependent exemptions.

In my experience I have found many of the taxpayers do not give correct W-2 forms. Some take exemptions for self and wife and others leave some of the children off until the final calculation of their income taxes. This abuse could well run the other extreme as well, taking more exemptions than they were actually entitled to.

If taxes (income are to be withheld) are to be prepaid, why are taxpayers allowed to do this. In fact they are withholding their taxes to be repaid at a later date. If a law or regulation could be instituted that every taxpayer was to have the proper exemptions executed on a current basis and no additional deductions allowed at a later period, this would facilitate matters for the Government in refunds to the various taxpayers. To me it would establish immediately an honest attitude toward their income-tax deductions. If one would likely lose their exemption unless currently corrected, it would certainly maintain a more level attitude. If they, too, could be subjected to a perjury clause for reporting illegally, it would also help to correct many discrepancies.

An employee can do things on his individual income-tax reports—assuming that no one else knows—but if he is held in line with proper exemptions used in his withholding-tax payments with no adjustments at the end of year—pro or con—you will see a definite change in the taxpayers' receipts.

Very truly yours,

MABEL A. WHITE.

SURVEY OF INTERNAL REVENUE CODE OF 1954, H. R. 8300—STATEMENT SUBMITTED BY DON W. HUBER, TUCKAHOE, N. Y.

MATTERS TO BE REVIEWED FOR REVOCATION OR AMENDMENT

1. Employee death benefits

(References: 1954 IRC sec. 101; Committee Rept. VII A, pp. 14 and A30.)

For the following reasons, the present limitation of $5,000 which a corporation may pay on a tax-free basis to the beneficiaries of a deceased employee should be retained rather than adopting a limitation of $5,000 on the amount the beneficiaries may receive as proposed:

(*a*) If the principle of such tax-free payments is correct, an employee's ability to work for more than one employer should not place a limitation upon the benefits to be realized.

(*b*) An employee with more than one employment contract calling for such payments may name various beneficiaries to receive such payments. The proposed form of limitation would present a complicated problem for determining the taxable status of payments received by the various beneficiaries.

2. Interest element in life-insurance proceeds

(References: 1954 IRC sec. 101 (d); Committee Rept. VII B, pp. 14 and A30.)

The proposed bill would tax the so-called interest element in installment payments of insurance proceeds after allowing an exclusion up to $500 and $250 for the decedent's widow and each child, respectively. For the following reasons, this provision should not be adopted:

(*a*) The insured, by exercising his options under an insurance contract to have the proceeds paid out in installments, is primarily motivated by providing for the future financial security of the named beneficiaries. In most cases, such beneficiaries are the insured's widow and/or his dependent children. Changing the tax-free nature of such installment payments would lead, in many cases, to an increase in lump-sum settlements in order for the beneficiaries to secure additional investment income to offset that lost to taxes. Past experience shows that lump-sum payments lend themselves to unwise investments and quick dissipation. Family security warrants the continued tax-free nature of installment insurance payments.

(*b*) Attempting to continue the tax-free concept of such payments through exclusions leads only to another element of confusion for the taxpayer.

(*c*) Increasing the exclusion sufficiently to overcome, in a greater measure, the argument expressed at "a" above would only add complications to the tax structure without materially improving tax revenues.

3. Net operating loss deduction

(References: 1954 IRC sec. 172; Committee Rept. IX J, pp. 27 and A56.)

The new revenue act retains, except for tax-exempt interest items, the same "economic loss" concept for determining operating loss deductions as in the current law. The law currently requires that dividends, capital gains, and percentage depletion in excess of cost depletion be deductible in computing the current year's operating loss or the amount of the unused operating loss carryover. This adjustment has the effect of subjecting these items, which normally receive preferential tax treatment and which are so taxed where the taxpayer has profitable operations, to the highest tax rates imposed on the taxpayer. This unreasonable tax burder should not be added as a further penalty to the corporation which suffers an operating loss. It is recommended that:

(*a*) The loss as computed for tax-return purposes should be the amount of the current year's operating loss. The amount of the unused carryover to prior or subsequent years should not be reduced by dividend income, etc.

(*b*) The idea of a 2-year loss carryback should be continued as proposed.

(*c*) The proposed exclusion of an operating loss carryback in computing allowable contributions should be continued as set forth in section 170 (b) (1) (B).

4. Certain amounts paid in connection with insurance contracts

(References: 1954 IRC sec. 264; Committee rept. XI A, pp. 31 and A65.)

This proposed code disallows interest paid as a deduction for tax-return purposes when the money borrowed was used—

(*a*) To purchase a single premium deferred annuity, or

(*b*) For the prepayment of a substantial number of future premiums on a life-insurance contract.

These provisions were added primarily to negate certain tax-avoidance schemes originating with the purchase of certain types of annuities where the creditor has no recourse against the owner of the contract, and the purchase of 5- or 10-pay life-insurance policies in which all or substantially all of the premiums were prepaid by means of loans. Action should be taken to correct such situations. However, blanket prohibition against such interest deductions is not required by the circumstances. Further, on the same subjects:

(*a*) *Deferred annuities.*—Deferred annuities have long been recognized as legitimate investments. Gain from the sale or other disposition of the annuity contract is taxable. If benefits are paid out under the contract to the annuitant, a portion of such payments in excess of the prorated cost of the contract is recognized as taxable income. Since taxpayers generally are permitted the deduction of interest on loans for investments in stocks, bonds, real estate, commercial paper, etc., there is no basis for prohibiting the interest deduction on

amounts borrowed to invest in a taxable annuity venture under circumstances where a true debtor-creditor relationship is established. Unless this is permitted under the law, steps should be taken to declare the gain and income elements of annuity contracts as nontaxable. This provision should be omitted and the matter of recognition of a true debtor-creditor relationship should be left to interpretive regulations under existing law.

(b) *Prepayment of life insurance premiums.*—There is a great and recognized need for life-insurance protection. Current tax rates, however, in many instances prevent the acquisition of such insurance protection out of after-tax income. In the same manner, taxpayers, generally, are unable to acquire the protection of a home except through amounts borrowed from financial institutions. If, therefore, a man desires to incur debt to insure the future financial independence of his dependents, he should be able to do so with the same tax advantages in regard to the capital needed for such a move as are granted in the purchase of a home or other types of investments. Such a debt must be valid. The taxpayer's credit must be placed in the balance so that there is full recourse against all of his assets should that step be necessary.

If there are certain situations where tax-avoidance schemes can be developed in regard to single-premium policies (IRC sec. 24 (a) (4) (6)), established law on this point could be amended to prohibit the interest deduction where:

(1) The total premiums prepaid equal or exceed the cost of a single-premium policy of the same class at the insured's attained age; and/or

(2) The premiums so prepaid exceed 75 percent of the total number of premiums which, under existing mortality tables, could be expected to be paid by the insured based on his then attained age.

Such limitations or definitions of the term "substantial number of future premiums" would clarify the intent of the law in this situation.

In no event should this provision of the proposed law be made applicable to the interest on such loans in effect on or prior to the date of enactment of the Internal Revenue Code of 1954, or the renewal thereof

5. Redemptions of stock—nonparticipating stock

(References: 1954 IRC secs. 302 (a) (1), 309 (a), 312 (b) (d); committee rept. XII A (2), pp. 35 and A72).

This subsection of the proposed act subjects "the redemption of nonparticipating stock" to the transfer tax of 85 percent under section 309. Section 312 (d) defines such stock as that which is not participating stock as defined in section 312 (b). Essentially, therefore, nonparticipating stock is of a class the earnings of which are limited and which is preferred in any respect except as to voting rights. Since an "and/or" connective was not used in section 312 (b), presumably both conditions are required.

This section should be amended to eliminate any question that the term "nonparticipating stock" does not apply to preferred stock which is not limited as to earnings. If, on the other hand, it is desired that all preferred stock fall into this category, the section should be amended to prevent its application to preferred stock issues outstanding as of the date of enactment of the new code.

6. Corporate reorganizations, acquisitions, etc.

(References: 1954 IRC 359 (b) and (c); committee rept. XII C, pp. 40 and A133.)

Subparagraphs (2) of the sections of the 1954 code above cited provide that the stockholders of a corporation merged with another corporation through a stock or asset purchase, in order to have a tax-free merger, must end up owning at least 25 percent of the stock of the transferee corporation. Such a provision would, for all practical purposes, prevent most, if not all, corporate acquisitions by large companies of smaller companies. Socialistic ideas applicable to the control and growth of big business should not be a part of this country's revenue laws.

This section should be amended to permit the tax-free consolidation of corporate business units regardless of the size of the surviving unit where such a move is warranted by the business reasons on which it is based.

KINGSTON MANUFACTURING CO., INC.,
Newmarket, N. H., April 13, 1954.

Hon. STYLES BRIDGES,
United States Senate, Washington 25, D. C.

DEAR SIR: You are undoubtedly familiar with bill H. R. 8300, a portion of which refers to accelerated depreciation of new machinery purchased since January 1, 1954, for income-tax purposes. We appreciate the fact that this clause was put in to stimulate the purchase of new machinery, which is a good thing.

On the other hand, this puts the small manufacturer, who can only afford used machinery to add to his production, at a disadvantage. The problem of the small man is how to obtain enough capital for maintenance and expansion from what is left after paying the 52 percent corporate tax. He is in many cases driven to buying a used machine, even though it may not be as efficient as a new one. On the other hand, large corporations have the capital to purchase new and more efficient machinery and are also given a tax advantage over the small man.

It seems to me that any machinery, new or used, purchased since January 1, 1954, should have the tax advantage to equalize things.

Cordially yours,

LESTER H. GIBSON.

INTERNATIONAL MILLING COMPANY,
Minneapolis 1, Minn., April 9, 1954.

Senator EDWARD J. THYE,
Washington, D. C.

DEAR SENATOR THYE: Our attention has just been called to the provisions of section 501 (e) of the proposed Internal Revenue Code of 1954 which we understand is now being considered by the Finance Committee of the Senate.

This section sets forth the requirements which a trust forming a part of a pension or profit-sharing plan must meet in order to be exempt from income taxation and is a rewriting of section 165 (a) of the present Internal Revenue Code.

The present section 165 (a) sets forth certain requirements for such a trust to be exempt and also provides that such a trust will be exempt which does not meet its specific requirements if it forms part of a plan for—

"Such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

The proposed section 501 (e) sets forth specific requirements which a plan must meet in order to qualify; however, there is no provision to the effect that a plan which does not meet such specific requirements can nevertheless qualify if the Commissioner approves the plan as being nondiscriminatory—a highly desirable provision in the present law which gives necessary flexibility in the actual operation of the law. The result of the proposed section 501 (e), in event it becomes law, is that a plan must meet the rigid, specific requirements set forth therein in order to be acceptable. Unless it is so changed that the Commissioner has discretion such as in the existing law, it is apparent that the new proposed law will prohibit many plans of types now in existence and many future plans which might be developed to meet particular situations and which would in no way be unfair or discriminatory.

It is accordingly our view that it would be unwise to enact into law specific requirements without also providing in the law for the approval of plans which though not meeting such specific requirements are nevertheless fair and nondiscriminatory.

Taking up some of the proposed specific requirements, the following are called to your attention as illustrations:

PENSION PLANS

1. The proposed section 501 (e) (3) (A) provides that a classification is discriminatory if more than 10 percent of the participants are "key employees," except that the classification shall not be considered discriminatory—

"in the case of an employer having more than 20 regular employees, * * * if 25 percent or more of all of such regular employees are participants * * *."

"Key employees" is defined to mean employees whose total compensation places them in the highest paid 10 percent.

Many companies may have or may wish to establish plans covering only salaried employees. In such a case, the foregoing provisions are to the effect that not more than 10 percent of the participants may be key employees or at least 25 percent of all employees must be participants. Take the case of a company with 2,000 employees, 1,700 of whom are paid by the hour and only 300 of whom are paid on a salary basis. If the plan covers only salaried employees, obviously 25 percent of all the employees of the company cannot be participants. Consequently, not more than 10 percent of the participants (or 30, assuming that all salaried employees are participants) may be key employees, and under the definition of "key employees," the plan, even though fair and nondiscriminatory, likely could not qualify. As key employees would be the highest paid 200 employees under the plan here illustrated, it would appear inevitable that more than 30 of the participants would be key employees.

2. The proposed section 501 (e) (4) provides that the "contributions or benefits" under a pension plan must not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of compensation may be disregarded. If this means that both the benefits and the contributions must be nondiscriminatory, then the provision is unreasonable since obviously in many, and probably in most plans, the contribution on behalf of an employee who is older than another must of necessity be more percentagewise in relation to his compensation than would be the percentage of contribution to compensation for a younger employee.

PROFIT-SHARING PLANS

What is stated above respecting coverage classification with respect to pension plans is also applicable with respect to profit-sharing plans.

In addition, the proposed section 501 (e) (4) (B) provides that at least 75 percent of the employer's contributions each year, and all of the amounts arising from forfeitures on termination of service or other reason, must be allocated in such manner that the allocated amounts do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower. It is also provided that the remaining contributions, if any, must be allocated in such manner that the total allocation, as a percentage of compensation, to any covered employee in any year does not exceed twice the minimum allocated to any other covered employee whose compensation is lower.

It is common in profit sharing plans to provide for allocating contributions according to a formula which gives one point or share for each $100 or each $250 of compensation (often up to a certain maximum) and one point or share for each year of service which the employee has completed, giving credit for service with the employing company and with affiliated and predecessor companies. When this type of formula is used, it gives desirable recognition to length of service, which is certainly fair and in no way unreasonable. An employee with longer service may well have more contribution allocated percentagewise to his compensation than would be the case for a lower paid employee having fewer years of service. Assume a formula giving 1 point for each $250 of compensation and 1 point for each year of service. An employee having 40 years of service and $6,000 of compensation would be given 64 points. An employee receiving $3,000 of compensation with 5 years of service would be given 17 points. This appears perfectly reasonable, but inasmuch as the younger employee did not have 32 points, the plan would not qualify under the law as now proposed.

It should also be noted that the proposed law makes more difficult the continuance and the development of plans which recognize the desirability of proportionately larger pension benefits for the lower compensated employees in relation to those having higher compensation.

It is also common in profit-sharing plans that forfeitures be treated as income of the trust fund, the same as dividends or interest, and that all such income be allocated to the various employes according to their respective interests in the fund at the time as shown by the balances then credited to their respective accounts. When this type of formula is used, which is certainly fair and in no way unreasonable, the proposed requirements would in many instances prevent the plan from qualifying.

The foregoing are only illustrations of what we wish to point out which is:

First, that the proposed requirements as drawn are much too limited and restrictive, and

Second, that it is not possible to write a rigid set of requirements which will be fair in every situation. In consequence, the law should contain a provision

which will permit plans which are fair and nondiscriminatory to qualify even though they do not meet the specific requirements set forth in the law. In other words, the law must have certain flexibility in order to be practical in operation.

The proposed law apparently contains a provision which states that existing plans now qualified under section 165 (a) of the present code may in the future retain their exempt status providing that they continue to qualify under that section. However, in administering that section, the revenue people, at some distant future date, may be inclined, in applying its general language, to follow the specific requirements of the new law. In addition, there of course will be many new plans established in the future and even amendments of existing plans which might in effect be interpreted as constituting new plans. The result will mean not only confusion, but might very well mean serious inequities with respect to the pension programs of hundreds of thousands of employees covered by existing plans. For these reasons, it seems to us that the proposed code should not be so written as to prevent qualification of plans which are fair and nondiscriminatory.

We realize that Members of the Senate and the House and the Treasury Department are just as desirous as employers and employees are to have a fair, equitable, and workable law. If you consider our comments meritorious, will you please forward the enclosed copies of this letter to the chairman of the Senate Finance Committee and to the Treasury Department, together with your comments.

Atherton Bean joins me in sending you our best personal regards.

Sincerely yours,

MALCOLM B. MCDONALD, *Vice President.*

INTERNATIONAL MILLING CO.,
Minneapolis, Minn., April 21, 1954.

Senator EDWARD J. THYE,
Washington, D. C.

DEAR SENATOR THYE: Some days ago Malcolm McDonald wrote you our views on certain provisions of the proposed Revenue Code of 1954 which relate to pension and profit-sharing plans.

We have now had an opportunity to examine with considerable care additional provisions of this proposed code. Incidentally, the more we get into this rewrite of the law, the more startled and alarmed we become at the terrific changes which are being made under the objective of simplification, etc.

In this letter we shall discuss section 302.

It is clear to us that this section as written will greatly hamper the continuance and development of small- and medium-sized businesses. It will obstruct the normal and proper mechanisms for transfer of ownership in the modest business which has little or no public market for its stock, and may indeed force drastic alteration or discontinuance of long-standing plans for employee common-stock ownership. This is so contrary to the stated position of the administration to encourage small- and medium-sized businesses and to promote widely based ownership in our free-enterprise society that we feel sure you will want to see that the section is completely rewritten.

We appreciate the necessity of protecting revenue sources, but it is also important to make sure that tax laws are not so written as to seriously affect the financial future of the countless number of nonpublic enterprises of our country which are really the base of our economy.

I am attaching a copy of a memorandum analyzing the specific provisions of section 302, setting forth ways in which they will adversely affect small- and medium-sized businesses generally, and suggesting ways in which we think these provisions should be changed. We are enclosing a number of extra copies of this letter and the attached memorandum which we shall appreciate your forwarding to Chairman Millikin, Senate Finance Committee; to the Treasury Department, and to Colim Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation.

You very kindly incorporated a copy of our memorandum relating to section 501 (e) of the proposed code in the record of the committee's hearings on the tax bill. If appropriate, we will appreciate similar action with respect to this memo.

Yours very truly,

HARRY E. HOWLETT, *General Counsel.*

SECTION 302

Section 302 is said to be a specific restatement of the general provisions of section 115 (g) (1) of the present Internal Revenue Code which provides that if a corporation redeems its stock—

"in such manner as to make the * * * redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed * * * to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

However, section 302 is much more than a specific restatement of this existing law. Its provisions are such that a shareholder who sells stock to the corporation will be taxed on the proceeds received the same as though such proceeds constituted a dividend, without any deduction for the amount which he had paid for the stock, in situations where the payments by the corporation for the stock are not either under existing law or otherwise essentially equivalent to the distribution of a dividend.

This section 302 has provisions which are unwarranted even when applied to public corporations, but its unwarranted and confiscatory nature—as demonstrated in the discussion of its specific provisions below—is particularly apparent when applied to corporations encouraging employee ownership of common stock and to small- and medium-sized nonpublic corporations generally whose shares have no real public market.

Thus, in an attempt to get at stock redemptions which are essentially equivalent to taxable dividends, the section has been so drawn that—

(*a*) it will greatly hinder if not render impossible a large stockholder selling a portion of his stock to the corporation for the purposes of resale to employees; and

(*b*) it will greatly restrict if not render impossible the reacquisition of stock from an employee in installments even though this is the only way the corporation can buy.

The penalties of the proposed section are so severe that it will also operate as a substantial deterrent against investing in any nonpublic corporation.

The shares of the vast majority of corporations are not listed on a stock exchange and do not otherwise have a real public market. The corporation itself is the only place where a fair price can be obtained. Many of these corporations in fact restrict selling to outsiders, requiring—for perfectly proper reasons—that the corporation be given the first option to buy. Why should anyone invest in such a corporation when, if he must sell a portion of his shares and can obtain a fair price only from the corporation or is otherwise required to sell to the corporation, he may well find himself subjected to regular income tax on the full amount he receives, the same as a dividend is taxed, without being permitted any deduction for the cost to him of the stock. He can invest in a corporation whose stock is listed on an exchange or whose shares otherwise have a real public market, and then when he sells he will be taxed at capital-gains rates and only on the excess of what he receives over what he paid for the stock.

Turning now to the specific provisions of section 302:

Under section 302, if when a company buys its stock the amount paid does not exceed its accumulated earnings (or its earnings for the current year even though it otherwise has a deficit), the full amount paid is treated as a dividend to the selling shareholder without deduction for any amount which he has paid for the stock unless one or the other of certain specificed requirements is met.

Note the requirements:

1. Section 302 (a) (1) provides that the shareholder will be taxed on a capital-gains basis provided the corporation has to pay the 85 percent tax imposed by section 309 and provided he sells only preferred stock.

This is of no value to a shareholder who wishes or is required to sell common shares.

Further, it will frequently be of little or no value to a shareholder wishing to sell only preferred shares. To require the corporation to pay the 85 percent tax imposed by section 309 will in many cases prevent the corporation from purchasing the shares.

2. Section 302 (a) (2) provides that the shareholder will be taxed on a capital-gains basis provided his stock is redeemed in connection with a partial or complete liquidation of the corporation.

This provision is of course proper, but it is of no value to shareholders of a going concern.

3. Section 302 (a) (3) provides that the shareholder will be taxed on a capital-gains basis provided he sells all of his common and preferred stock to the corporation at one time.

This provision is of no value to a shareholder who wishes or is required to sell only part of his shares.

Further, under section 302 a shareholder is deemed to own all stock, both preferred and common, which is owned by his spouse, children, grandchildren, or parents, and he and each of such persons is deemed to own all shares owned by a trust or a corporation in which he or such a relative has a specified interest even though neither he nor the relative can dictate the decisions of the trustee or the board of directors. Implicit in these provisions is the erroneous theory that all members of a family act as a unit which is simply not the case.

Take the case of a shareholder who for reasons of hardship, or for other reasons, wishes to sell his shares and where the only available real market is the corporation. He should not be subjected to the provisions of section 302 simply because one or the other of his spouse, children, grandchildren, or parents, or some trust or corporation also owns shares in the corporation which they do not wish to sell or which the corporation refuses or is financially or otherwise unable to buy.

It is true that section 302 provides that an individual shall be deemed, for the purposes of section 302 (a) (3), to own only those shares which he himself owns or which a trust or corporation in which he has a specified interest owns, provided—

(*a*) he sells all shares, both preferred and common, which he owns,

(*b*) all trusts and corporations in which he has a specified interest also sell all shares, both preferred and common, which they own even though he cannot dictate the decisions of the trustee or the board of directors,

(*c*) he ceases to have any other interest in the corporation either as an officer, director, or employee, or otherwise (excepting only a creditor interest), and provided that he does not acquire any interest (except by bequest or inheritance) for 10 years thereafter, and

(*d*) he has not received any part of the stock redeemed as a gift nor made a gift of stock within 10 years, a principal purpose of which was the avoidance of income taxes.

These provisions are unrealistice and in operation would be extremely inequitable because they compel the shareholder to dispose of his entire interest in the corporation, and also require all trusts and corporations in which he has a specific interets to dispose of all of their shareholdings, even though he cannot dictate their decisions, and also impose other conditions which are not warranted. How can anyone foresee for 10 years ahead whether or not he may under any and all circumstances, however compelling and valid the reason, never be called upon to again become, within 10 years thereafter, a director, officer, or employee of, or to make an investment in the corporation?

4. Section 302 (a) (4) provides that the shareholder will be taxed on a capital-gains basis provided the payment he receives for his stock is "substantially disproportionate."

It is provided that such a payment shall be deemed to be substantially disproportionate—

"only if, immediately after such (purchase) such shareholder owns a percentage of the fair market value of the participating stock of the corporation which is less than 80 percent of the percentage of the fair market value of such stock owned prior to such distribution."

This means if any shareholder is to sell to the corporation, he himself—unless he owns less than 1 percent of the outstanding common stock as discussed below—must sell sufficient to meet the test or otherwise the full amount he receives will be taxable as a dividend and without any deduction for the amount he paid for the shares.

This is true—

(*a*) even though his shares are the only shares purchased by the corporation and no other shareholder is affected with the result that the payment made to him is not proportionate to other shareholders as a dividend would be;

(*b*) even though he does not wish to sell but because of an exercise of an option or call is required to sell and the option is not exercised with respect to sufficient shares to meet the test;

(*c*) even though what he sells meets the test as respects the shares he he himself owns, but the test is not met because one or the other of his spouse, children, grandchildren, or parents, or some trust or corporation also owns shares and does not wish to sell or, if willing to sell, the corporation refuses or is unable for financial or other reasons to buy; and

(*d*) even though he paid as much for his shares as what he receives from the corporation.

Take the case of a shareholder owning 30 percent of a corporation's common shares. Assume he sells 10 percent of his shares to the corporation (or only 3 percent of the corporation's outstanding common shares) in a situation where no other shareholder also sells. He may so sell because—

(i) he wishes to sell in order to make the shares available to the corporation for resale directly or through affiliates to employees—a situation which should be encouraged rather than discouraged; or

(ii) he is forced to sell because of the exercise of an option or call; or

(iii) he needs the funds and the corporation is the only real market either because there is no public market in which a fair price can be obtained or because selling to the public is restricted by contractual obligations.

No one of these situations—and each is a real situation common to many existing corporations—involves a situation essentially equivalent to a taxable dividend. The shareholder may have held the shares which he sells for many years. He may receive from the corporation no more than what he paid for the shares which he sells. However, because the disproportionate test of section 302 is not met, the full amount he receives is under that section taxable to him as a dividend without any deduction for what he paid for the shares. This is plain and simple confiscation.

There is another real objection to this provision. The disproportionate rule is made to apply to the fair market value of the shares immediately before and immediately after the purchase by the corporation. Use of market values makes the rule uncertain in operation and opens the door to numerous disputes. The test should be—if there is to be any such test—a comparison of the percentage of the number of common shares outstanding owned by the selling shareholder immediately before and immediately after the purchase.

5. Section 302 (a) (5) provides that the shareholder will be taxed on a capital gains basis no matter what portion of his shares he sells provided he holds less than 1 percent of the common stock of the corporation.

It should be here noted that in the vast majority of small corporations it is an exceptional case where any shareholder would own less than 1 percent of the common stock.

The unfairness and confiscatory nature of such an exceedingly restrictive maximum is illustrated by the example given in (4) above with respect to a shareholder owning 30 percent of the corporation's common stock.

What is so stated above with respect to such a shareholder is also applicable to one owning a percentage even greater than 30 percent. No shareholder should be subjected to a tax on the sale of any part of his shares to the corporation as though the proceeds were a taxable dividend except possibly—

(*a*) where he owns sufficient of the common shares of the corporation to give him in fact control of it and purchase from him is in fact not disproportionate; and

(*b*) where the corporation simultaneously redeems a portion of all of its common stock pro rata to the holdings of each of its shareholders in such a manner as to make the distribution proportionate the same as a dividend would be.

In addition to the illustrations referred to above, take the case of a shareholder in a corporation who is an employee of it and who owns only 2 percent or 5 percent or 10 percent of the common stock but holds the same subject to an option to purchase any or all thereof. The corporation for many years has followed the commendable policy of employee ownership of its common stock and wishes, when he ceases to be an employee, to exercise the option. However, the shares, even though only a small percentage of the total outstanding, have a very substantial value, and the corporation is unable at one time to buy all or sufficient to meet the disproportionate test—either because the corporation is financially unable to do so or is restricted by financing agreements or charter provisions or otherwise—and the corporation accordingly exercises the option to purchase what it can. The shareholder may well find himself in the position of being subject to a tax, as a dividend is taxed, on the full amount which he receives and without any deduction for what he paid for the shares. He may

have even borrowed funds to finance his purchase of the shares and find himself in a situation where, after paying the tax on the so-called dividend which he has received, he does not even have enough left from the amount received from the corporation to pay his debt or the balance of the debt which he incurred for the purpose of buying the shares. The same would be true where the shareholder voluntarily sells only part of his holdings without there being any option exercised.

6. Section 302 (a) (6) provides that the shareholder will be taxed on a capital-gains basis if the payment received for the stock is one to which section 303 is applicable, that is, a redemption to pay death taxes as there provided.

This is of no value to a living shareholder.

Further, section 303 permits of a redemption of shares only in situations where—

(*a*) the shares comprise more than 35 percent of the value of the gross estate of the decedent, or

(*b*) an amount equal to more than 50 percent of the taxable estate of the decedent,

and the redemption is limited to the amount necessary to pay death taxes and funeral and estate administration expenses.

There should be no limit on the portion of the estate which the shares must comprise. To impose a limit assumes that the balance of the estate will be in liquid assets whereas in fact it may be in land and property holdings which cannot be sold except at an extreme sacrifice.

PREFERRED STOCK

Further, section 302 should not apply to redemptions of preferred stock no matter how much of its common stock is also owned by the shareholder except possibly in the one situation where the preferred stock has been recently issued as a dividend pro rata on the outstanding common stock.

Take the case of a shareholder who owns 1½ percent of the common stock of the corporation and also owns shares of its preferred stock. The corporation may purchase or call a portion of the preferred stock as it is required to do under the sinking-fund provisions with respect to which the stock was issued or the corporation may wish to call all of the preferred stock in order to refinance by replacing the issue with a new issue having a lower dividend rate. The full amount which the shareholder receives from the corporation for his preferred shares in this situation is taxable as a dividend to the shareholder under section 302 and without any deduction for what he paid for the preferred stock. Actually he may have paid as much for the preferred shares as the company pays him. The confiscatory nature of the section is obvious.

Section 302 before enactment into law should be changed in at least the following particulars—

(1) A shareholder should be permitted to deduct his cost basis of the stock which he sells to the corporation except possibly in the one situation where the corporation simultaneously redeems shares of all the shareholders pro rata to their holdings;

(2) A shareholder should be deemed to own only those shares of stock which he himself directly owns. He should not be deemed to own shares which his parents, spouse, children, or grandchildren own or which a trust or corporation owns where decisions of the trustee or the board of directors must be made on the basis of what is best for the trust or corporation and all persons interested in it or in accordance with the provisions of the trust indenture or corporate charter or bylaws;

(3) The section should not apply to redemptions of preferred stock except possibly in the one situation where the preferred stock redeemed has been recently issued as a dividend pro rata on the outstanding common stock;

(4) The disproportionate test should be changed from the 80-percent figure in the proposed law to at least a 95-percent figure. Further, the disproportionate test should apply, not to the percentage of the fair-market value of the common shares owned by the selling shareholder immediately before and immediately after the purchase by the corporation, but to the percentage of the outstanding common shares owned by the selling shareholder immediately before and immediately after the purchase by the corporation;

(5) The maximum interest permitting capital-gains treatment for any sales to the corporation without having to apply the disproportionate test, which in

the proposed law is less than 1 percent, should be increased to at least 50 percent. In other words, section 302 should not apply to the acquisition of any portion of the common stock of any shareholder who owns less than such percentage of the corporation's outstanding common stock as will give him control of the corporation unless possibly in the one situation where simultaneous redemptions are made pro rata as to all of the shareholders. The 50-percent figure is suggested because that is the figure used elsewhere in the proposed code as a line of demarcation between a shareholder who does or does not control a corporation.

INTERNATIONAL MILLING CO.,
Minneapolis, Minn., April 22, 1954.

Senator EDWARD J. THYE,
Washington, D. C.

DEAR SENATOR THYE: I wrote to you yesterday respecting section 302 of the proposed Revenue Code of 1954, and now wish to call your attention to the provisions of section 309.

Section 309 is so drawn that any corporation such as ours, which has issued preferred shares, not as a stock dividend on, but in exchange for common shares will be required, on redemption or purchase of any of the preferred shares, to pay a tax equal to 85 percent of the amount it pays on such redemption or purchase.

We are required by contract to call or otherwise purchase our preferred shares periodically for sinking fund purposes. We may wish sometime to call the entire issue for refinancing purposes. Acquisition of our preferred shares is certainly proper in either case, and yet in either case this section 309 would require us to pay a tax equal to 85 percent of the amount we pay on call or other purchase of the shares.

There is no justifiable reason for the imposition of this proposed tax in such a situation. Where a shareholder surrenders shares of common stock in exchange for preferred shares he gives value therefor and does not receive the preferred shares as a dividend. If any of the preferred shares are subsequently redeemed, the shareholder is entitled to and should be taxed on a capital gains basis and the corporation should not be taxed at all.

There have been and there will properly be recapitalizations by many corporations pursuant to which preferred shares have been or are issued in exchange for common shares. In fact, many corporations such as ours have a class of common or other shares now outstanding which by the provisions of the corporation's articles are convertible into preferred shares, and we and such other corporations are required to issue preferred shares whenever any holder of such convertible shares elects to convert in accordance with the contractual provisions.

The situations mentioned are only a few of the many where section 309 imposes an 85 percent tax which is simply not warranted as pointed out in more detail in the attached memorandum.

We are enclosing a number of extra copies of this letter and attached memorandum which we shall also appreciate your forwarding to Chairman Millikin, Senate Finance Commitee; to the Treasury Department, and to Mr. Colin Stam, chief of staff, Joint Committee on Internal Revenue Taxation. If appropriate, we will also appreciate your having a copy included in the record of the Senate Finance Committee's hearings on the tax bill.

Yours very truly,

HARRY E. HOWLETT, *General Counsel.*

SECTION 309

Section 309 imposes a tax on the corporation on the transfer of securities, money, or other property paid by it in redeeming any of its preferred stock within 10 years after date of issuance equal to 85 percent of the amount so transferred, except that this tax shall not apply—

(1) if the transfer is made as part of a partial or complete liquidation;

(2) in the case of redemption of preferred stock from the original recipient, " to the extent that there is redeemed as part of the same transaction the amount of (common) stock with respect to which the (preferred) stock was issued";

(3) if the transfer is a redemption of preferred stock issued for securities or property (or which takes the place of preferred stock which was so issued), "to the extent of 105 percent of the fair market value of such property";

(4) if the transfer is treated under section 302 (b) as a "distribution not in redemption of stock" or, for example, if it is treated as a dividend;

(5) if the transfer in redemption qualifies under section 303 respecting redemptions to pay death taxes.

It is provided that preferred stock shall be deemed issued on the date of issuance or January 1, 1954, whichever date is later (sec. 309 (c)).

In situations where a corporation has issued preferred stock as a dividend on its outstanding common stock, a subsequent redemption of such preferred stock might enable the common stockholders in effect to receive a distribution of earnings taxable at capital-gains rates rather than at ordinary dividend rates had a cash dividend been paid. The purpose of section 309 is apparently to prevent this from happening.

This section is so worded, however, that it goes far beyond accomplishing such a purpose and in effect imposes a confiscatory tax in situations where there is no justifiable reason therefor. If this section is to be enacted, it accordingly should, before enactment, be changed to limit its application to the redemption only of that preferred stock which has been issued without consideration and as a dividend on outstanding common stock.

Actually, section 309 should not be enacted at all because—

(1) it is included in an income-tax bill and yet imposes a tax against a corporation having no relation to its income;

(2) if there is any situation where a preferred shareholder should be taxed on any distribution received on redemption of his preferred shares, that shareholder is the one who should be taxed. By taxing the corporation, this proposed section in effect taxes all of the shareholders of the corporation without regard to whether they did or did not own any of the preferred shares which were redeemed and, as to those who did, without any relation to the distributions which they respectively received.

The confiscatory nature of the proposed section may be illustrated by the following:

1. If preferred stock has been issued for securities or property, the section exempts from the tax that portion of the payment made by the corporation which does not exceed 105 percent of the fair market value of the property which the corporation so received.

This section would thus impose an 85 percent tax in the following situations in each of which such a tax would be confiscatory:

(*a*) If the preferred stock had been issued for securities, the tax would apply on the full amount paid on redemption of the preferred shares because a corporation's securities are not "property" within the meaning of the law;

(*b*) If the preferred stock had been issued for common shares either in connection with a refinancing or recapitalization or on conversion of convertible common shares into such shares, the tax would apply on the full amount paid on redemption of the preferred shares because a corporation's own shares are not "property" within the meaning of the law.

Thus, in either of the situations mentioned, if a corporation purchased its preferred shares issued either for securities or its own common stock, it would in addition to the price it pays be required to pay a tax of 85 percent of the amount so paid. If the section is to be enacted at all, it should before enactment be changed to provide that preferred shares issued in exchange for common shares (either on conversion or otherwise) or securities of the issuing corporation shall be treated the same as preferred shares issued for property and that the corporation shall be treated as having received property for its preferred shares so issued in the amount of the fair market value at the time of the exchange of the stock or securities which it so received.

A shareholder who surrenders securities or shares of common stock in exchange for preferred shares gives value therefor and does not receive the preferred shares as a divedend. If the preferred shares are subsequently redeemed, the shareholder is entitled, to and should be taxed on a capital gains basis and the corporation should not be taxed at all.

2. The provisions exempting from the tax that portion of the payment made by the corporation which does not exceed 105 percent of the value of the property received by the corporation on issuance of the preferred shares is defective for other reasons including—

(*a*) Many preferred stock issues for perfectly proper business reasons have a call price which is in excess of $105. Even though the shares may have been issued for $100 cash per share, a call of the shares at a call price in excess of $105 would subject the corporation to an 85 percent tax on whatever it pays in excess of $105; and

(*b*) Where a corporation has issued shares for $100 cash per share and later exchanges new shares on a basis of say 1$\frac{1}{20}$ new share for each previously

issued share, the corporation will have received less than $100 for each of the new shares. In this situation, a call price of only $105 would subject the corporation to the 85 percent tax on approximately $5. The reason for having made an exchange on such a basis might well be for legitimate business reasons as, for example, to encourage holders of outstanding preferred shares to exchange for new preferred shares having a lower dividend rate.

3. This section is defective also in certain other respects.

For one thing, it does not take into account contractual obligations incurred, previous to enactment of the law or otherwise, whereby the corporation is required to purchase or redeem at periodic intervals a certain portion of its outstanding preferred stock for sinking fund purposes. Certainly, every corporation should be permitted to observe its contractual obligations without penalty.

Also, if any class of stock, common or otherwise, is convertible into preferred shares, the corporation where such contractual obligations already exist is required to continue in the future to issue preferred stock on such conversions. The preferred stock required to be issued doubtless will have contractual provisions requiring periodic purchases or redemptions for sinking fund purposes, and the corporation should not be penalized for fulfilling its contractual obligations.

4. Section 309 provides that it shall not apply in any case where the payment by the corporation is treated under section 302 (b) as a distribution not in redemption of stock.

In other words, every corporation acquiring preferred shares, either in small amounts for sinking fund purposes or otherwise, must ascertain whether or not the preferred shareholder also owns 1 percent or more of its common stock. In many cases it could not do this because of its common stock being held in the name of nominees or in the names of trustees, the minute provisions of the trust instruments not being known, or by corporations in which the shareholder might have sufficient stock interest to make him deemed to be the alter ego of the corporation.

Even if the corporation could ascertain which of its preferred shareholders own less than 1 percent of its common stock, it might not be able to call its preferred stock so as to avoid penalizing such shareholders, because under its charter provisions it may well be required to call its preferred stock—even when only a small portion of it is to be called—by lot.

5. This section provides that it shall apply to redemptions of preferred stock within 10 years after issuance and that preferred stock shall be deemed to have been issued on the date of issuance or January 1, 1954, whichever date is later.

The law should not apply to any preferred stock issued prior to enactment of the law and accordingly at a time when such drastic consequences of a subsequent redemption could not have been known. Further, since the law applies to redemptions of future issues only within 10 years after date of issuance, there is no valid reason why the law should apply to previous issues which may have been made 10, 20, or 30 years ago.

At the very least, redemptions of previous issues should not be restricted after 10 years from date of issue any more than redemptions of future issues.

BOISE, IDAHO, *April 15, 1954.*

HON. HENRY C. DWORSHAK,
United States Senate, Washington, D. C.

DEAR SENATOR DWORSHAK: I have been informed that H. R. 8300 has passed the House of Representatives and is before the Committee on Finance of the Senate.

I am writing to you in reference to section 38 of that bill, and asking your support in reinstating provisions of H. R. 5180 (the Mason bill), which provided for exemption from income tax of retirement income up to $1,500, instead of up to $1,200, as provided in H. R. 8300, and to not confine these benefits to persons age 65 and over.

One-third of the employee annuitants on the civil service retirement rolls on June 30, 1953, was under age 65. The greater part of these annuitants retired because of disability, with resultant periodic, if not continuous, medical expenses. Many of them have been victims of illness brought about by the service which had been their careers, and could no longer carry on, and thus lost many productive years. Too, persons under 65 who have because of illness been forced to retire, very often have dependents, and retirement income in these years of high prices is wholly insufficient to support a family.

Yes, I am one of those annuitants, who at the age of 54 was stricken with a vascular accident, brought about by hypertension and 30 years of service as a national-bank examiner. At that time I was supporting, besides my wife, a 19-year-old son in his second year of college, a 16-year-old son in his third year of high school, and a 9-year-old daughter in the fourth grade. Our sons, through their own efforts, have stayed on in school, but you can well understand how difficult it is to maintain a family on retirement income and pay income taxes thereon.

I believe the annuitants under the age of 65 are as much entitled to relief from taxation to the amount of $1,500 as are those over that age, and I seek your assistance in restoring the benefits of the Mason bill to section 38 of H. R. 8300, now before the Senate Committee on Finance.

Very truly yours,

ROBERT E. A. PALMER.

MINNEAPOLIS-HONEYWELL REGULATOR CO.,
Minneapolis, Minn., April 15, 1954.

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

DEAR SENATOR MILLIKIN: The management of this company has been keenly interested in the progress of the Internal Revenue Code of 1954 and has given serious thought and considerable study to its potential impact upon our industry and business in general. In our opinion, the overall task which has been accomplished by its draftsmen is outstanding. It deserves the constructive support of all men interested in seeing our future economy prosper.

In reviewing and studying subchapter C, we are in general agreement with the new approach to the taxation of corporate distributions, liquidations, and rearrangements. This new approach should eliminate tax loopholes and, at the same time, aid corporate taxpayers generally by providing specific statutory standards to be applied in a given set of circumstances. Subchapter C, however, is of necessity extremely complex, and we seriously fear that for the sake of clarity and specific statutory standards this subchapter may inadvertently prevent the occurrence of wholly desirable business arrangements. We refer particularly to the new 25 percent participating stock-ownership test, which is a prerequisite to tax-free corporate acquisitions as defined in section 359 (b) (2) and (c) (1). We strongly urge the removal from the new code of this 25 percent stock-ownership test.

The existing Internal Revenue Code in section 112 (b) (3) has long provided that: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance to the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." We believe very strongly that it is wrong to alter this basic philosophy permitting tax-free reorganization. The very large amounts of capital necessary for experimental research and development purposes and for beginning production of new products often make it most difficult or impossible for closely held corporations with valuable new products to fully develop the use of those products without merging with existing publicly held corporations.

In our own experience, we have found that in acquiring the assets of a going business the inventive, engineering, and managemet skills of key persons in the organization are usually one of the most valuable assets. We have always been anxious to arrange for the continued services of such personnel, as well as for the assignment of the actual tangible assets.

We believe that the 25 percent participating stock limitation overlooks completely the further limitation imposed by section 359, which requires that in an exchange 80 percent of the property, or 80 percent of the stock, must be acquired solely for participating stock. With that requisite the necessary continuity of interest is now maintained, and it is assumed that the shareholders of the transferor are participating owners of the transferee. No arbitrary standard fixed by statute or otherwise will guarantee that shareholders actually participate in the management of the transferee company, and it is believed that the new code should not attempt to prescribe this by arbitrary standards.

For the reasons stated, while we wholeheartedly recommend support of the Internal Revenue Code of 1954, we emphatically urge the elimination of the 25 percent participating stock rule with respect to corporate acquisitions.

Very truly yours,

J. H. BINGER.

STATEMENT OF LUTHER C. STEWARD, PRESIDENT, NATIONAL FEDERATION OF FEDERAL EMPLOYEES, WASHINGTON, D. C., ON H. R. 8300

Mr. Chairman and members of the committee, on behalf of the membership of the National Federation of Federal Employees we wish to request that you amend section 38 of H. R. 8300 to provide that all annuities paid under the provisions of the Civil Service Retirement Act be exempted from income tax. This would include Federal employees who have retired at an earlier age than 65, as well as those who have retired because of disability. This latter group is usually subject to greater expense than those who are not disabled.

Another group who deserve consideration are the widows who are receiving annuities under the Civil Service Retirement Act, who under the provisions of H. R. 8300 would not be exempt from income tax.

At the 1952 convention of the National Federation of Federal Employees the following resolution was unanimously adopted:

Whereas annuities paid under the Railroad Retirement Act are not subject to Federal income tax; and

Whereas benefits paid under the Social Security Act are also exempt: Therefore be it

Resolved, That the National Federation of Federal Employees go on record as favoring and urging the enactment of legislation exempting annuities under civil-service retirement laws from Federal income tax.

We urge favorable action to remedy the existing injustices that still exist in H. R. 8300.

FEDERAL BAR ASSOCIATION OF NEW YORK,
NEW JERSEY, AND CONNECTICUT,
New York 5, N. Y., April 16, 1954.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

(Attention Mrs. Elizabeth Springer, Clerk.)

DEAR MRS. SPRINGER: On April 12, as chairman of the Federal tax committee of the Federal Bar Association of New York, New Jersey, and Connecticut, I communicated with your committee, directing my criticism against the jeopardy assessment section of the Internal Revenue Code of 1954. This letter will further serve to clarify the objections and make the appropriate suggestions for amendment to the code sections in question.

The jeopardy assessment sections as now written are unduly harsh and inflict upon many taxpayers an unjust and impossible restraint. The original intent and purpose of the jeopardy assessment provisions was to enable the Bureau of Internal Revenue to protect its revenue against the admitted or true absconder, concealer, or criminal racketeer who acts willfully and deliberately to evade the payment of income taxes. Unquestionably a very laudable objective.

Unfortunately, however, their original purpose has, to a considerable extent, been lost sight of and these sections and their uses have been so broadened and extended that the businessman taxpayer faced with a jeopardy assessment is confronted with the stigma of guilty until proven innocent.

The present code sections fail to set up proper standards. The only criterion is the belief of the Internal Revenue Service that in its opinion and judgment the collection of the tax would be jeopardized, and that a jeopardy exists.

The use of the jeopardy assessment method of collection may be, and is applied against the true absconder or racketeer as well as the taxpayer businessman. Only the judgment of the Service is required to set in motion this means of collection.

The use of the jeopardy assessment, under the present code provisions enables the Internal Revenue Service to make an immediate levy and assessment upon all of the taxpayer's property, bank accounts, assets, businesses and anything else that might be available or visible. The taxpayer can be reduced to almost immediate poverty, his business can be destroyed, liquidated, and disposed of without giving him the proper opportunity for having the matter heard on its merits. Whether or not this procedure is warranted rests solely upon the judgment of the Service.

The only relief available to such an aggrieved taxpayer is either the immediate payment of the amount of the total jeopardy assessment, which, of course,

is almost an impossibility, in the average case, or the filing of a bond, generally in double the amount of the jeopardy assessment. And usually a surety company bond is required. Any taxpayer, or his representative, who has at any time ever attempted to obtain such a bond would realize immediately the futility of this so-called remedial measure.

There is a duty, of course, upon the Commissioner of Internal Revenue to follow up the jeopardy assessment with a notice which the taxpayer must receive within 60 days after the levying of the assessment—a notice which permits him to file a petition with the Tax Court of the United States. In due course (a period of time which may be anywhere from 6 to 18 months) the matter will be heard by the Tax Court of the United States and a decision rendered as to the validity, not of the jeopardy assessment, but of the amount involved in the jeopardy assessment. The mere filing of the petition with the Tax Court of the United States does not in any way stay the right of the Internal Revenue Service to proceed with the collection of the tax under the jeopardy assessment provisions. Even though the court may eventually decide that the taxpayer is innocent or that the amount of the deficiency is less than the sum assessed, the damage has in most instances long since been done.

In partial recognition of the harshness of the jeopardy assessment provisions as they exist presently, Congress enacted a law August 14, 1953, which gives the Commissioner or his duly designated representatives, the right to abate the jeopardy assessments if they find that the jeopardy does not exist.

This, however, is a long drawn out, cumbersome procedure which in no way serves to avoid the disastrous results of a jeopardy assessment against a businessman taxpayer who is unable to furnish the requisite bond or pay the assessment. While such an application may be made, it is still entirely discretionary with the Commissioner and, in the meantime, the assessment and levies have been made. Almost invariably the final determination of the amount due on a jeopardy assessment has been found to be considerably less than the amount originally assessed.

It is unfortunate that the jeopardy assessment provisions have in many instances been misused and applied against taxpayers who should have been permitted to contest and determine the validity of their tax deficiencies through the usual orderly processes of tax assessment and appeal.

There is not the slightest question that the jeopardy assessment provisions have in the past and do now serve a very useful purpose and should be retained, but they should be modified to permit relief, which they do not now, to certain classes of taxpayers.

It is suggested that these sections of the proposed Internal Revenue Code be amended to permit the filing of an immediate formal claim for abatement of the jeopardy assessment which would have the effect of immediately staying all assessments and levies until the responsible officers of the Internal Revenue Service can act upon such petition for abatement. And it is further suggested that, in addition to such a claim for abatement, the bond-filing requirements be changed so that the aggrieved taxpayer may be able to file a bond in the exact amount of the jeopardy assessment, or in such lesser amount as may be determined, without the use of a surety company, and that such bond be permitted to be in normal form.

Very truly yours,

SAMUEL S. STARR,
Chairman, Federal Tax Committee.

COMMITTEE ON PERCENTAGE DEPLETION FOR SLATE,
April 16, 1954.

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

DEAR SENATOR MILLIKIN: We understand that the Senate Finance Committee started hearings on tax revision bill (H. R. 8300) on Wednesday, April 7.

We also understand that your committee will not hold hearings on any duplicate testimony which was presented at the tax revision hearings conducted by the House Ways and Means Committee last summer.

In view of the above, we would like to file statement for the record requesting your committee to retain in the bill, House action which included slate under a 15-percent depletion allowance, thereby putting slate in a more competitive

position with other competing minerals. We refer you to our testimony presented on August 14, 1953, before the House Ways and Means Committee.

Respectfully yours,

W. F. BRONKIE,
Secretary-Treasurer.

THE AMERICAN TOBACCO CO., INC.,
New York, March 17, 1954.

Re H. R. 8300, Report No. 1337, chapter 52—Tobacco, Cigars, Cigarettes, and Cigarette Papers and Tubes, section 5703 (a)

Hon. EUGENE D. MILLIKIN,
Senator from Colorado, Chairman, Senate Finance Committee, United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: As H. R. 8300 introduced by Mr. Reed of New York will soon reach the attention of your Senate Finance Committee, the problem of the American Tobacco Co. is respectfully called to your attention.

On page 95 of the report of the Committee on Ways and Means, House of Representatives, it is stated as follows:

"Under present law taxes on these products are paid for by the purchase of stamps which must be affixed to packages or containers prior to or at the time of removal of the products from the factory or other bonded premises. Because of this procedure, producers must finance tax payments between the time the stamps are purchased and the time they receive payment for the taxed products from their vendees. Such financing increases the working-capital requirements of producers by many mililons of dollars, and the producers have requested that they be permitted to pay the taxes on a delayed-return basis as is provided in the case of most other excises. Your committee's action recognizes the burden of the present system on producers and provides a method whereby a changeover can be made to a delayed-return system."

To carry out this intention of the Ways and Means Committee to provide for a deferred method of payment section 5703 (a) of House Report 8300 provides in part as follows:

"The taxes imposed by section 5701 shall be determined at the time of removal of the articles and shall be paid by the manufacturer or the importer thereof by return."

The remainder of the section provides that the Secretary or his delegate shall by regulation prescribe the period for which the return shall be made, the information to be furnished on such return, the time for making such return, and the time for payment of such tax. It is also provided that the tax shall continue to be paid by stamp until January 1, 1955, and continue thereafter until the Secretary or his delegate shall by regulation provide for the payment of tax by return.

It can be readily seen, therefore, that the committee report, recognizing the inequity of the present system of prepayment, supports the deferred payment plan. The proposed statute prepared and submitted by Treasury does not give any affirmative relief in this respect to the tobacco industry. When, if ever, the changeover from the prepayment to the deferred payment system will take place is left under the proposed legislation entirely to the discretion of the Secretary of the Treasury.

The Treasury Department, in conferences with the industry as well as in statements made to the Ways and Means Committee, has endorsed the deferred payment method but has objected to a changeover at any definite time on the ground that such a changeover would occasion a deficit during the year of changeover and disturb the Treasury balance. To meet this objection, and with the desire of early legislation to correct the inequities occasioned by the present method of payment of tobacco excise taxes, we propose a compromise, which in our judgment would meet every reasonable objection that has been urged by the Treasury. A copy of our proposal as submitted to the House Ways and Means Committee is attached hereto.

Under this proposal there is an ultimate system of deferred payment made on the 15th day of the month following the calendar month in which the tax attaches, but the Treasury is given discretion to determine the time of placing this system in effect. In the meantime, however, under our proposal the industry would be afforded specific and substantial relief for 11 months of each year on an interim deferred payment basis, but for the last month of each fiscal year would prepay into the Treasury Department on an estimated basis the balance

of its entire tobacco excise tax liability for the full fiscal year. Under this method the industry would receive some measure of relief and yet the Treasury Department would be receiving during its full fiscal year approximately the entire amount which it would receive if these taxes continue to be collected on a cash or certified check basis.

It seems obvious to us that such a method should overcome any reasonable objections from either the industry or the Treasury Department and would carry out the avowed intention of the proposed statute. Accordingly, it is respectfully submitted that your committee give serious consideration to this proposal so that the relief requested and certainly warranted may be forthcoming some time in the very near future.

Respectfully yours,

JAMES R. COON,
Vice President.
GEORGE W. WHITESIDE,
General Counsel.

PROPOSED REVISION OF SECTION 5703 (A) OF CHAPTER 52, INTERNAL REVENUE CODE

(a) PAYMENT OF TAX.—The taxes imposed by section 5701, whether denoted by stamp or otherwise, with respect to all products taxable under said section shall be paid on the 15th day following the close of each calendar month (1) by the manufacturer upon removal during such calendar month from the place of manufacture or from the possession, control, and bond of the manufacturer at any duly designated bonded premises, or (2) by the importer upon removal from the custody of the customhouse officers or from a duly designated bonded warehouse, in accordance with such regulations as the Secretary may prescribe, provided, however, that, should the Secretary find that the fiscal needs of the Treasury so require, he may by regulation defer the effective date of this subsection by providing that pursuant to said regulation and during such period of deferment such taxes shall be paid on the 25th day of each month for the period from the 21st day of the preceding month to and including the 20th day of the current month except that for the month of June, whenever such month occurs during such period of deferment, there shall be paid in addition to other taxes due during such month, a tax upon articles which the taxpayer estimates will be removed during the remainder of such month of June. The Secretary may by regulation provide for the payment of a penalty, not to exceed 5 percent of the amount of tax underestimated, in the event that such estimated tax shall be less than 80 percent of the tax actually due upon articles removed during such remainder of such month of June.

OGILBY, HUHN & BARR,
ATTORNEYS AND COUNSELORS AT LAW,
Washington, D. C., April 20, 1954.

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

MY DEAR SENATOR: I should like to bring to your attention a suggested revision of section 216, amounts representing taxes and interest paid to Cooperative Housing Corporation, of subtitle A, chapter 1, subchapter B, part VII, of the Revenue Code of 1954, being H. R. 8300.

This section, in brief, provides a deduction to tenant-stockholders for amounts paid to cooperative housing corporations to the extent that such amounts represent the tenant-stockholder's proportionate share of real-estate taxes paid by the corporation and of interest on its indebtedness paid by the corporation. This section has extended the coverage of the previous code provision, which referred to cooperative apartment corporations, to include cooperative housing corporations.

The problem to which I allude is equally applicable under the existing code section, as it will be under the proposed revised section, and concerns cooperative apartment corporations which are nonstock membership corporations and which have neither stockholders nor any class of stock outstanding. Under this type of cooperative, the counterpart of shares of stock are "cooperative apartment ownership contracts" which are issued one to each apartment in the building. The capital value of the building (determined by the sales price) is fixed in the certification of incorporation and therein allocated to each such contract. Membership in the corporation is limited to owners of cooperative apartment

ownership contracts, which replace both a stock certificate and the usual perpetual lease.

This has proved to be a popular and successful type of cooperative ownership, since it reduces and combines the necessary forms and has a greater psychological appeal to owners in that they feel they are not buying shares of stock but are buying the apartment itself. Many buildings have been organized on this form, among them the Broadmoor at 3601 Connecticut Avenue NW., and the Ontario at 2853 Ontario Road NW. This method of cooperating is identical with that used under the stock plan save only that the aforesaid contracts replace stock certificates and perpetual leases. It would seem, however, that the members of these corporations are excluded from the benefit of this section because of technical wording and references to stock, just as cooperative housing corporations were similarly excluded because of technical wording and references to cooperative apartment corporations.

I make no pretense whatsoever to being a draftsman of statutes but I am enclosing a copy of section 216 in which I have inserted language which I felt would cover this class of cooperatives. The words I have inserted are underscored in red pencil; in no other respect have I changed the section. My primary purpose in doing this was to emphasize my feeling that the language should and need be changed only slightly.

I have no hesitancy in stating that I believe the spirit of both the existing provision and the proposed provision cover our cooperatives, and I trust very much that the language of the provision may be brought into conformity.

I have previously forwarded a letter similar to this to Mr. Colin Stam, chief of staff of the joint committee, together with a copy of section 216 as I suggest that it be revised and a copy of the Ontario certificate of incorporation and a copy of the Ontario cooperative apartment ownership contract. I hesitated to burden you with papers, but I would be very happy to forward you copies of the two latter documents if you desire them.

I would greatly appreciate such consideration and attention as you and your committee can give to this problem.

Very truly yours,

REMSEN B. OGILBY.

SEC. 216. AMOUNTS REPRESENTING TAXES AND INTEREST PAID TO COOPERATIVE HOUSING CORPORATION.

(a) ALLOWANCE OF DEDUCTION.—In the case of a tenant-stockholder (as defined in subsection (b) (2)), there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—

(1) the real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated, or

(2) the interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation on its indebtedness contracted—

(A) in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) in the acquisition of the land on which the houses (or apartment building) are situated.

(b) DEFINITIONS.—For purposes of this section—

(1) COOPERATIVE HOUSING CORPORATION.—The term "cooperative housing corporation" means—

(A) a stock corporation having one and only one class of stock outstanding, or a non-stock-membership corporation.

(B) each of the stockholders or members of which is entitled solely by reason of his ownership of stock in or membership in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder or member of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) TENANT-STOCKHOLDER.—The term "tenant-stockholder" means an individual who is a stockholder in a cooperative housing stock corporation or a member in a cooperative housing non-stock-membership corporation, and whose stock or other legal evidence of ownership is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

(3) The term "tenant-stockholder's proportionate share" means that proportion which the stock of or other legal evidence of ownership in the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of or other legal evidence of ownership in the corporation (including any stock or other legal evidence of ownership held by the corporation).

LESTER HERRICK & HERRICK,
San Francisco, Calif., April 19, 1954.

MRS. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: Your attention is directed to subchapter N, subpart E, sections 941–943, inclusive, of the proposed Revenue Act of 1954.

These sections relate to the tax treatment of corporations organized under the China Trade Act of 1922. Section 941 would permit a special deduction which would be equal to the proportion of the taxable income derived from sources within China, which the par value of the shares of stock owned on the last day of the taxable year by: (1) Persons resident in Formosa, the United States, or possessions of the United States, and (2) individual citizens of the United States, wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on said date. The definition of China has been deleted from the code. Apparently the purpose of the deletion is to eliminate that part of China which is under communistic domination. But, because the term "China" is not defined, there is no assurance that Hong Kong and Macao are treated as part of China, as they are under the present code.

Under section 943, distributions by China Trade Act corporations would be excludable from gross income only if the distributee is a resident of Formosa. This limitation to Formosa appears to be discriminating as to stockholders of the China Trade Act corporations that reside in Hong Kong and/or Macao.

It will be appreciated if these particular sections are brought to the attention of the Senate Finance Committee so that it can be made clear whether the term "China" includes Hong Kong and Macao.

Thanking you, I am,

Respectfully yours,

HAROLD E. ALBER.

KENTUCKY ASSOCIATION OF INSURANCE AGENTS,
April 16, 1954.

Re Tax justice for fire and casualty insurance companies

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

DEAR SENATOR MILLIKIN: Please refer to my request to appear before the Senate Finance Committee representing the Kentucky Association of Insurance Agents in connection with your hearings on H. R. 8300. On April 6 a telegram from Elizabeth B. Springer requested a written statement of our views which could be included in your executive session. Needless to say, I am sorry that it is not possible for our views to be presented personally.

As a local insurance agent of Louisville, Ky., I am expressing the views of the Kentucky Association of Insurance Agents. Our organization would like to give you the worm's-eye view of how the present tax inequity directly affects

us stock insurance agents as we go about our daily business of selling and servicing capital stock insurance.

The present tax inequality produces two principal results: (1) The United States Treasury is deprived of upwards of $70 million each year, and (2) the mutual insurance companies enjoy a competitive advantage over the capital stock companies that we represent.

Section 207 of the Internal Revenue Code provides that mutual fire and casualty insurance companies must pay the regular corporate income tax on investment income, or 1 percent of gross income (excluding dividends to policyholders), whichever produces the higher tax. Of course, the capital stock insurance companies are taxed on exactly the same basis as other business corporations, that is, on both their investment and underwriting net income (without any dividend allowance). In other words, a special section of the code has been set up for mutual fire and casualty insurance companies. Why should mutuals enjoy this special tax provision which places them at a competitive advantage and derives the United States Treasury of tremendous revenue?

The large commercial mutuals write the same types of property and casualty insurance as the stock companies; they use the same general kind of underwritings; they seek the same prospects. Since the two types of organizations operate in such a similar manner, we see no reason for giving one type a tax advantage over the other.

If the Congress is not disposed to change the tax as applied to mutual companies, we feel that the capital stock fire and casualty insurance companies should be given the same privilege of optional methods of taxation as are granted the mutual companies under section 207. Certainly you are aware that the mutual life insurance companies and the stock life insurance companies receive identically the same treatment under the Federal tax laws. If the mutual life insurance companies and the stock life insurance companies are treated exactly the same under the tax laws, why should the mutual fire and casualty insurance companies have a separate and distinct statute which favors them over their competitors?

To sum up our point of view, there is absolutely no reason why our mutual competitors should enjoy a tax advantage over the stock insurance companies that we represent. If the average taxpayer realizes that the is paying higher taxes because mutual fire and casualty insurance companies are not paying their fair share, he would be just as interested as we agents in having this tax law changed.

Sincerely yours,

JAMES W. HARRIS,
Chairman, Tax Equality Committee.

MINNESOTA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS,
Minneapolis, Minn., April 19, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

SIR: The taxation committee of the Minnesota Society of Certified Public Accountants requests the privilege of addressing this letter to you in your capacity as chairman of the Senate Finance Committee. It is the considered judgment of our committee that H. R. 8300 (Revenue Act of 1954) as enacted by the House of Representatives is a masterpiece of draftsmanship and that it also recognizes the need for legislation to amend and clarify the present Internal Revenue Code to grant long needed equities and to eliminate unwarranted litigation and controversies. Certain provisions of H. R. 8300 are objectionable to our committee and it is the purpose of this letter to bring them to your attention.

The members of our society service taxpayers who may be grievously affected by certain provisions of H. R. 8300. For this reason, they believe it their duty to direct the known grievances to your attention for action which will eliminate or at least alleviate the hardships imposed upon our taxpayers by H. R. 8300. The captioned references in this letter are those set forth in the House bill:

Section 34 (a) (1) and section 116 (a)

There should be no segregation of dividends received during the year and the credit should be allowed for all dividends received after December 31, 1953, with the same percentage limitations applicable as prescribed in subsection (b) (2).

This is believed to be equitable otherwise complicated prorations and adjustments will have to be made of the dividends received before and after July 31, 1954.

Section 165 (e)

The allowance of a deduction for theft loss should be changed to permit the deduction in the year of discovery or the year of the loss. Many inequities could result from the provisions set forth in the House bill. The year of discovery could possibly be a low-income year for a taxpayer incurring a theft loss with the result that he would obtain little or no tax relief therefrom.

Section 243 (a) and section 246 (b)

Our committee believes that the credit for dividends received by a domestic corporation should be increased to 100 percent to eliminate even the partial double taxation of such dividends. The House bill, in section 246 (b), prescribes limitations and restrictions which limit the credits to 85 percent of net income without regard to the amount of dividends received. This latter provision does not do away with the double taxation of dividends received by corporatons.

Section 309

Amend this section to provide for taxation of redemptions of nonparticipating stock issued after the enactment of the new code. The section should be further amended to exempt stocks issued for cash or, if this is contemplated by the House bill, the definition of property in section 309 (a) (3) should be expanded to include money. It is believed that serious inequities and injustices would result from the retroactive application of this provision, particularly with respect to such stocks issued many years ago but which, under the House bill, are deemed to have been issued on January 1, 1954.

Section 332 (b)

As presently worded, this section does not allow a full credit for distributions received in the liquidation of foreign subsidiary corporations, as provided in the present code. Section 332 (b) provides for a credit of 100 percent of the liquidating distributions received by a domestic corporation subject to the provisions of section 243 (a), which limits such liquidating distributions to those received from domestic corporations only. It is believed that Congress did not intend to amend the present law so as to tax fully the liquidation dividends of foreign subsidiaries which are exempt under the present code. It is thus respectfully requested that section 332 (b) be revised to clarify this intent by allowing a full credit for liquidating dividends received by a domestic corporation from its foreign subsidiary corporations.

This section is further deemed to be inequitable in that it would tax the entire amount of a liquidating distribution received from a foreign subsidiary without regard to the domestic corporation's investment therein. In the alternative, a deduction should be allowed for the cost of the stock in the foreign subsidiary corporation and the gain derived from the liquidation should be treated as a gain from the sale or exchange of such stock (capital gains tax rate).

Section 381

This section is quite vague with respect to the right of a successor corporation by merger or otherwise to the carryovers (net operating loss, capital loss, etc.) incurred by and ordinarily allowed to its predecessors. The section should be revised to make clear that the carryovers apply to one or more of a series of successions. Specifically, it is believed by our committee that the section should be revised to provide, in addition to all of the specific items listed therein, that for all purposes the successor should be permitted to stand in the shoes of the predecessor.

Section 421

Our committee believes that, in the case of plans involving stock in closely held corporations, a formula should be provided which the corporation may elect to use for stock-valuation purposes. The formula may be based upon book value or a specified number of years' earnings and it would be applied solely for qualification purposes. The section should be revised to recognize a backstop formula such as the book value of the stock or a specified number of years' earnings.

Section 461 (c)

The limitation of the deduction only to real property taxes erroneously excludes the same accounting methods applied to the accrual of personal property taxes

and all other property taxes. The recommendation is made from an accounting standpoint by a group fully acquainted with this problem that the word "real" be deleted so that the section can apply to all real, personal, use, occupancy, severance, and similar taxes that are imposed upon the use and ownership of property.

Section 481

This section of the House bill permits the Commissioner of Internal Revenue to select the best year in which to make the authorized adjustments at considerable cost to the taxpayer. It is suggested instead that, in the case of an involuntary change in accounting method, that the adjustments be spread out in accordance with the principles of section 1311 (present sec. 3801) or over such lesser period of time as the Commissioner and the taxpayer may agree. As a matter of equity, this would prevent the Commissioner from bunching sales and inventory adjustments, in the case of an involuntary conversion from the cash to the accrual method of accounting by businessmen and farmers, over so short a period as to work an inequity on such taxpayers.

Section 505 (a) (7)

Our committee objects to the limitation of 5 percent of the total trust assets placed by the House bill on investments in the securities of any one corporation by approved employees' trusts. Present employees' trusts have much greater leeway under the present law and it is sometimes desirable that they invest in the securities of the employer corporation in recognition of a true profit-sharing motive. It is suggested that the limitation be removed but, in the alternative, that the limitation be imposed only upon new employees' trusts created and approved after enactment of this section.

Section 736 (a)

This section works on unwarranted inequity upon retired or deceased partners and upon continuing partners by reason of the necessary contractual obligation sometimes undertaken by a partnership to pay off the retired or deceased partner within or after 5 years of his retirement or death. It is suggested that the 5-year limitation be eliminated but, if a limitation is deemed necessary by your committee, it is then suggested that it be extended to at least 10 years. Furthermore, it is also suggested that any payments, not deductible by the continuing partners, be allowed to increase the basis of their individual partnership interests. Conversely, the payments received by the former partner or his estate should be recognized as part of the sales price of his partnership interest and the gain, if any, thereon should, therefore, be considered to be a capital gain in the same way as the gain upon the sale of any capital asset.

Section 1231

This section seems to confound section 117 (j) of the present code in that it does not add but may even detract from the present law. Our committee recommends that the language and intent of the present section 117 (j) be incorporated as part of the proposed code. We definitely oppose any proposition that the aggregate net gain be treated as anything but a capital gain and that the aggregate net loss be treated as anything but an ordinary loss as allowed and recognized by section 117 (j) of the present code. As a matter of equity, it is further recommended that the provisions of the present section 117 (j) be extended to include assets held for less than 6 months.

Section 1501

This section imposes an inequity in that it requires the consent of all members of an affiliated group be obtained before a consolidated return can be filed. This would enable a less-than-95-percent-owned subsidiary, which was sold before the introduction of the House bill, to nullify the consolidated return election because the control thereof passed to outside hands. It is recommended that this inequity and unreasonable requirement be removed.

Section 1505 (a) (2)

It is the unanimous opinion of our committee that annual elections to file consolidated returns be authorized in the proposed code. It is further believed that the present 2-percent surtax penalty be removed and that corporations be granted the option to file annual consolidated returns without the payment of any additional surtax. Our committee favors no alternative; it strictly believes that consolidated returns should be permitted to be filed annually at no additional surtax penalty.

Section 6051

This section requires employers to furnish withholding receipts to terminated employees "on the day on which the last payment of remuneration is made." From experience, our committee knows that this requirement is sometimes impossible to meet during the year. In the usual course, the terminated employee either loses or mislays his receipt with the result that another is requested of the employer at its considerable expense in preparation and mailing. It is recommended that all withholding receipts required by this section be furnished to the terminated employee by mail or otherwise at his last-known address on or before January 31 of the year succeeding his termination. This recommendation will permit an employer to mail or deliver all withholding receipts at the same time during the year.

Section 6075 (b)

This section requires gift returns to be filed by March 15, while section 6072 permits the filing of calendar-year individual income-tax returns by April 15. Since individual taxpayers are prone to associate income and gift-tax returns as a single requirement, and, in many respects, the preparation of either or both are dependent upon the other, it is recommended by our committee that the filing date of both calendar-year income- and gift-tax returns be set for April 15 of the year following and that the filing date for the same fiscal-year returns be set to be the 15th day of the 4th month following the end of the fiscal year. In other words, it is recommended that the filing date of gift-tax returns be made to conform with the filing date of individual income-tax returns.

Section 6654 (a)

This section would penalize individual taxpayers who filed declarations prior to the enactment of the proposed code. In the interest of such taxpayers and as a matter of equity, our committee strongly recommends that the provisions of the proposed section 6654 (a) be made applicable to taxable years beginning after December 31, 1954.

Section 7502 (a)

This provision of the proposed code treats as timely filed any documents (other than returns) mailed to the proper office within the time prescribed by the code or other internal-revenue laws. The mailing time is deemed to be indicated by the postmark on the envelope and the document is, in such circumstances, required to be accepted by the particular office even though it is received after the expired time. It is our committee's unanimous opinion that the same privileges should be extended to all tax returns and claims and also to petitions filed with the United States Tax Court.

It is respectfully requested that your committee give consideration to our grievances and recommendations and that action be taken thereon before the proposed Revenue Code of 1954 is reported out of the Senate Finance Committee for action by the Senate and the joint committee. If we can be helpful further in clarifying the views of many taxpayers, please do not hesitate in calling upon us.

Yours very truly,

FOR TAXATION COMMITTEE OF MINNESOTA SOCIETY OF C. P. A'S,
A. E. ZATARGA, *Chairman.*

THE FAFNIR BEARING CO.,
New Britain, Conn., April 19, 1954.

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

MY DEAR SENATOR MILLIKIN: There are several matters in the tax revision bill (H. R. 8300) about which I desire to offer an opinion. They are as follows:

Depreciation

I recommend that the declining balance method be approved as an elective method in writing off investments in plant and equipment, at a rate up to twice the straight-line rate now permitted. This would permit the writeoffs of approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of its cost in the first half of its life.

It is obvious and should be recognized that assets depreciate in value much faster in the earlier periods of life and use.

Double taxation of corporate profits

The present double taxation should ultimately be eliminated by exempting corporate dividends from individual income tax. Pending this ultimate relief, the proposal of President Eisenhower for giving increasing relief over the next 3 years should be supported.

Tax on capital gains and losses

At present, gains from sale of capital assets (stocks, bonds, etc.) are taxed at special rates for both corporate and individual taxpayers. However, losses from the sale of capital assets, which exceed similar gains, are not deductible at all for corporations and only to a limited degree for individuals. It seems fair that this inequity should be eliminated by treating gains and losses in a similar manner.

Corporate tax rates

During World War II the corporate and normal surtax rates did not exceed 40 percent and shortly after the war the rate was reduced to 38 percent. In the light of this historical background, it would appear that the 52 percent rate, and even the proposed 47 percent rate, are excessive. It is my sincere belief that lower corporate and normal tax rates will stimulate the expansion of small- and medium-sized corporations to the extent that the eventual tax receipts by the Federal Government will not suffer.

I hope that the above suggestions will merit the attention of your committee.

I am sending copies of this letter to Senators Purtell and Bush, of Connecticut.

Sincerely yours,

MAURICE STANLEY.

FAIRCHILD, FOLEY & SAMMOND,
MILLER, MACK & FAIRCHILD,
Milwaukee, Wis., April 19, 1954.

Re. H. R. 8300, pension plan provisions

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

DEAR SENATOR: We wish to direct your attention to a portion of H. R. 8300 dealing with pension plans which, if enacted into law, would accomplish an unfortunate result that was apparently not intended by the House of Representatives.

Section 165 (a) of the Internal Revenue Code now in effect relating to the exemption from tax of pension and similar employee-benefit plans includes as one of the conditions for exemption the following requirement:

"(a) EXEMPTION FROM TAX.—A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall not be taxable under this supplement and no other provision of this supplement shall apply with respect to such trust or to its beneficiary—

* * * * * * *

"(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

It is possible under this language to provide a year-of-service factor in computing benefits under a pension plan without sacrificing the plan's exempt status.

On the subject of discrimination of contributions or benefits, section 501 of the proposed code as included in H. R. 8300 reads as follows:

"(a) EXEMPTION FROM TAXATION.—An organization described in subsection (c), (d), or (e) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, 504, or 505.

* * * * * * *

"(e) EMPLOYEES' PENSION TRUSTS, ETC.—The following organizations are referred to in subsection (a): A trust created or organized in the United States and forming part of a stock bonus, pension or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries—

* * * * * * *

"(4) RATIO OF CONTRIBUTIONS AND BENEFITS.—If—

"(A) in the case of a pension or annuity plan, the contributions or benefits of or on behalf of the employees under the plan do not bear a higher ratio of compensation for any covered employee than for any other covered employee whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded;".

Subsection (e) (4) (A) if read literally would preclude the consideration of years of service in a pension-plan benefit formula in almost every case. It is difficult to imagine a plan whereunder some higher-paid employees would not have more years of service at retirement age than some lower-paid employees; yet only where there could be no such higher-paid employe would it be possible to base retirement benefits in part upon length of service without violating the proposed subsection.

The House of Representatives committee reports with reference to sction 501 do not indicate an intent to eliminate the consideration of years of service in pension plans. The sole purpose of section 501 (e) (4) (A) appears to be the elimination of "the complex problems encountered under present law in combining the private benefits with social-security benefits under the so-called integration rules." H. R. Rept. No. 1337, 83d Congress, 2d session 45 (1954). This purpose is accomplished by the exception clause and is not dependent upon the "higher ratio of compensation" language.

The recognition of years of service is an integral part of pension planning: Such recognition is included in countless plans which have been qualified under section 165 (a); it decreases employee turnover and thereby results in greater efficiency; and it affords the opportunity for proportionately greater reward to those employees, low paid as well as high paid, who spend a lifetime with their employer.

In short, the social desirability of recognizing years of service in computing pension benefits is beyond question. Accordingly, we urge your committee to recommend the revision of proposed section 501 (e) (4) (A).

Very truly yours,

FAIRCHILD, FOLEY & SAMMOND,
By HERBERT P. WIEDEMANN.

O. M. SCOTT & SONS CO.,
Marysville, Ohio, April 19, 1954.

ELIZABETH B. SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MADAM: May we bring to your attention the accompanying statement concerning the effect of the proposed Revenue Code of 1954 on employee's pension and profit-sharing trusts.

One of our directors attended the recent schooling on this subject in New York and the attached statement is the result.

With best wishes, we are

Cordially yours,

C. B. MILLS.

STATEMENT RE EFFECT OF PROPOSED REVENUE CODE OF 1954 ON EMPLOYEES' PENSION AND PROFIT-SHARING TRUSTS

Based on advice we have received concerning the effects of the proposed new tax legislation on our pension and profit-sharing trusts for the benefit of our employees, it is our opinion that the legislation will be unfair, inequitable, and discriminatory to the detriment of our company and its employees.

In support of this position, we cite the following points:

1. The new legislation limits any one investment in real estate to an amount not greater than 5 percent of the value of the total assets of an employee trust

This will prevent our employee trusts from owning the real estate of our company and leasing it to the company. Thus, by making the lease rental taxable to the trusts (*a*) the trusts will be disqualified from making sound and profitable investments and (*b*) the investment opportunities otherwise available to our employee trusts will be reserved and monopolized by the big insurance companies.

No tax consequences are imposed by reason of investment in the common stock and other securities of the employer company but the prohibitive tax is imposed when the investment takes the form of a purchase of the employer's real estate although the latter investment is clearly a safer and probably more profitable medium for investment of the trust funds. It is submitted that both investments should continue to be allowed by employee trusts without restriction.

2. The new legislation imposes a discriminatory tax rate of 52 percent (30 percent on the first $25,000 and 52 percent on all income above $25,000) on lease-rental income of employee trusts as compared with effective rates of 3¾ percent (on the first $200,000 of net investment income) and 6½ percent (on the excess over $200,000) for insurance companies making similar investments in the real estate of the employer company

Clearly, the new legislation discriminates in favor of the large insurance companies and provides a windfall to them. For all practical purposes employee trusts are prohibited from investments in rental property with a resulting monopoly in this field to insurance companies which are generously provided with a substantial tax advantage.

If any tax is to be imposed on the so-called unrelated income of employee trusts, the rate should be made to correspond with those applicable to insurance companies making the same type of investment.

3. The limitation on investment in real estate to 5 percent of the value of the total assets of the trust will eliminate all possibility of real-estate investment, from a practical point of view, since this provision will require constant revaluation of the trust assets and possible disposition of real estate and disruption of lease agreements in order to keep the trust qualified and its investment in line with the onerous limits specified in the new legislation

Uncertainty and confusion will be injected if it is necessary to revalue trust assets and review real-estate investments quarterly and to limit such investments at all times to a percentage of the total value of the trust assets. The result will be, in effect, total prohibition of investments in real estate. This is an unwarranted and unfair provision to the detriment of employee trusts.

SPECIFIC RECOMMENDATIONS FOR AMENDMENTS

1. Amend section 505 (a) so as to permit investment in real estate owned by or leased to the employer corporation without limitation.

(*a*) This will provide a safer and superior investment for the employee trust, will encourage employee interest in the prosperity and business of the employer company and will assist the employer company in financing its capital requirements, to the mutual advantage of the shareholders and employees.

2. Amend section 505 (a) (6) so as to permit investment in real estate owned by or leased to persons other than the employer corporation to an extent not greater than 25 percent of the value of the total assets of the trust at the time of the investment.

(*a*) This will provide diversity of investment in nonemployer organizations and will eliminate the uncertainty of real-estate investments arising upon quarterly revaluation of trust assets.

(*b*) Twenty-five percent instead of 5 percent is suggested because 5 percent of the assets of most trusts would be so small as to prohibit real estate investments by employee trusts.

3. Amend section 511 so as to impose a tax on unrelated business income at rates not exceeding those applicable to the net investment income of life insurance companies.

(*a*) This will eliminate the unfair, inequitable and discriminatory taxation of investment income earned by employee trusts at relatively high corporate income rates (30 percent normal and 22 percent surtax, for a total of 52 percent applicable to income over $25,000) and will assure equal tax treatment (3¾ percent on first $200,000 and 6½ percent on net investment income above $200,000) as between employee trusts and insurance companies investing in real estate.

Your earnest consideration of these proposed amendments is respectfully requested, with a view to protecting the interests of shareholders and employees of all companies and avoiding the imposition of discriminatory taxes.

Respectfully submitted.

C. B. MILLS, *President.*

LESLIE E. HOWELL, C. P. A.,
Indianapolis, Ind., April 19, 1954.

Subject: Amendment to section 1000 (f) of the Internal Revenue Code relating to election by spouses to split a gift made by one of them.

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, 25, D. C.
(Attention: Elizabeth Springer, Clerk.)

GENTLEMEN: You are at the present time considering the new tax bill which is known as H. R. 8300 and is to revise the internal revenue laws of the United States.

In 1951, your committee gave consideration to changes in code sections 23 (aa) and 51. The Senate committee report, report No. 781, 82d Congress, 1st session, provided that the election to file separate or joint returns and to use a standard deduction frequently requires informed tax knowledge not possessed by the average person. In other words, the committee thought the binding elections which were provided worked a hardship upon the taxpayers.

Your committee at that time did not give consideration to amending section 1000 (f), relating to the gift tax, which also provides a binding election upon filing a return by taxpayers, and accordingly works a hardship on taxpayers as did the elections required in sections 23 (aa) and 51, prior to their amendment.

There is no doubt that this election works a hardship upon the taxpayers and accordingly the time within which taxpayers may exercise the right to their election should be extended to correspond to the period of statute of limitations to correspond to the period of making an election as is provided in sections 23 (aa) and 51. The conditions confronting the taxpayer as now provided in section 1000 (f) are exactly the same as those presented to the taxpayers in sections 23 (aa) and 51 of the code, prior to their amendment in 1951, and accordingly section 1000 (f) should be amended so that the taxpayers, in making gifts, have the same length of time for making a decision accorded them as is accorded taxpayers making a decision under sections 23 (aa) and 51. Certainly the anticipated revenue loss, if any, from these amendments will be negligible.

I earnestly solicit your most serious consideration to amending section 1000 (f) of the Internal Revenue Code so that taxpayers making gifts may exercise the right to change their election and file joint returns at any time within the period of the statute of limitations.

In view of the fact that the amendments to sections 23 (aa) and 51 were made effective with respect to taxable years beginning after December 31, 1950, I recommend the amendment to section 1000 (f) be made to give effect to any returns filed subsequent to December 31, 1950.

The foregoing request for

1. An amendment to section 1000 (f) so that taxpayers may exercise the right to change their election and file a joint return at any time within the period of the statute of limitations; and
2. That the amendment be made to become effective for all returns filed subsequent to December 31, 1950,

conforms in all respects to the relief granted taxpayers by the amendments which were made to sections 23 (aa) and 51 in the Revenue Act of 1951. These changes were recommended by the Senate committee at that time, and I should like for this committee to now give serious consideration to this amendment which I have proposed.

Very truly yours,

LESLIE E. HOWELL.

MERRILL, TURBEN & CO.,
Cleveland 14, Ohio, April 19, 1954.

Senator EUGENE D. MILLIKIN,
United States Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: Our attention has recently been called to the provisions of section 309 of the proposed Internal Revenue Code of 1954, which was passed by the House of Representatives as H. R. 8300 and is presently pending before the Finance Committee of the United States Senate.

We believe that the provisions of section 309 are unjust and confiscatory in levying a prohibitive penalty tax in the amount of 85 percent of the redemption price on the redemption of nonparticipating or preferred stocks, unless the par-

ticular stock satisfies one of the listed exemption provisions. The proposed section 309 is so drawn that the 85-percent penalty applies, not only to preferred stock which was originally issued for tax avoidance purposes, but also applies to preferred stock which was issued for legitimate business purposes.

To illustrate the unjust and confiscatory nature of section 309 of the proposed new code, I merely can refer you to its effect upon our corporation in the event of my death or the death of any of my associates within 10 years, which would be to destroy our efforts over a period of many years in building this business. We have preferred stock outstanding, originally issued for a legitimate and bona fide corporate business purpose a number of years ago upon the merger of an Ohio corporation and a Delaware corporation, and there are no accrued and unpaid dividends on the preferred stock. In the merger the shareholders of one corporation received only preferred stock. The preferred stock is held primarily by those who are not active in the company, thereby making it possible for younger men more active in the business to purchase and acquire an equity interest. The stockholders have agreements with the company obligating the company to purchase at the par value all preferred stock which any of us or other members of our family own at the time of our respective deaths. If the corporation were forced to pay a tax of 85 percent of the amount paid on redemption of preferred stock, it would obviously destroy the company.

The preferred stock was originally issued for value and on a fair basis at the time of the merger and represents a very substantial capital investment in our company. This preferred or nonparticipating stock cannot qualify for any of the exemptions under section 309, and therefore the corporation's existence would be proscribed by the continuance of the section in its present form.

Having spent my entire business life in dealing with securities in the financial field, I am of course familiar with many instances, in some of which my recommendations were made, where through corporate reorganizations or mergers preferred stock or nonparticipating stock has been issued. At the time of original issuance and at the present time such stock was issued for a legitimate and bona fide business purpose. From my experience in the financial field, I am sure that in the future, as in the past, similar preferred stock financing will in many instances be the only sound or feasible method for organizing or continued financing of certain business organizations. Yet the proposed new section 309 would destroy those corporations in a way exactly similar to its effect upon Merrill, Turben & Co.

Even if the proposed section 309 applied only to nonparticipating stocks to be issued in the future, I seriously question whether it would be a wise legislative policy thus in effect to prohibit future corporate reorganizations or mergers of the type I described. It would be just one more legislative restriction on legitimate corporate financial structure. However, if the only way to eliminate this particular source of income tax avoidance is in effect to prohibit all such corporate reorganization or refinancing, then in all fairness its application should be limited to nonparticipating preferred stocks created in the future. I strongly urge that the Finance Committee of the Senate propose an amendment to this section 309 establishing an additional exemption for nonparticipating preferred stock issued prior to January 1, 1954, as an equitable and logical method of avoiding inequitable and confiscatory results.

Sincerely yours,

CHARLES B. MERRILL, *President.*

JUDD & GURFEIN,
New York, N. Y., April 19, 1954.

Mrs. ELIZATH B. SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: In connection with the revision of the Internal Revenue Code which is pending before the Senate Finance Committee, I hope that section 505, concerning limitation on investments in profit-sharing trusts, may be amended.

1. As that is now drafted, item (7) states that investments shall be "limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and 10 percent of the combined voting power of all classes of stock of such issuer."

Violation of this provision would, under the draft, result in loss of tax exemption for an otherwise qualified trust. While it may be intended that a trust can invest more than 5 percent of its funds in a single issue provided the investment

does not represent 10 percent of the voting securities of the issuer, this is not clear.

As one of the trustees of a newly formed profit-sharing trust, I have made investments in the past month which exceed 5 percent of the total assets of the trust. In fact, in a moderate-sized trust, which grows by annual payments from the employer, it would hardly be feasible to divide the initial investment into 21 or more securities, as the present section might require. One of our investments was 100 shares of American Telephone & Telegraph Co., which represents an infinitesimal portion of that company but constitutes more than 10 percent of the total assets of the trust. If we were to buy any smaller number of shares, we could not obtain the benefit of a round-lot price.

2. The draft creates another serious inequity in that it is retroactive to March 1. Thus, investments made after March 1, without knowledge of the existence of the law, may be treated as retroactively destroying the tax exemption of the qualified trust, with no possibility of curing the situation.

I hope that you can bring these matters to the attention of the committee and that it may give some weight to these suggestions before the bill is reported in final form.

Very truly yours,

ORRIN G. JUDD.

CONTINENTAL NATIONAL BANK OF FORT WORTH,
Fort Worth, Tex.

Hon. EUGENE MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: H. R. 8300, Internal Revenue Code of 1954, passed by the House of Representatives, is now before the Senate Finance Committee for consideration and report.

Subdivision (d) (2), dealing with nonbusiness debts under section 166, as set out in H. R. 8300, reads:

"(d) NONBUSINESS DEBTS.—

"(2) NONBUSINESS DEBTS DEFINED.—For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than—

"(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business; or

"(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

Recently, while in Washington, I discussed with Mr. Colin F. Stam, chief of staff of the Joint Committee on Internal Revenue Taxation, an amendment to the foregoing definition of nonbusiness debt, with the result that there would be added to the above quoted subdivision (A), reading:

"(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business."

the following additional language:

"or the trade or business of another, which debt of another the taxpayer is obligated to pay to the original or any subsequent holder, as endorser, guarantor, indemnitor, or in any other capacity".

Prior to 1942, if an individual had a bad debt, it was fully deductible against his income, but since 1942, unless the bad debt was incurred in the taxpayer's trade or business, it is deductible only against capital gains.

I am impressed with the fact that the real substantial test for allowing a nonbusiness debt to be charged against the taxpayer's income is whether the money realized from the creation of the debt was lost in a trade or business. As subdivision (d) (2) of section 166 in H. R. 8300 now reads, the nonbusiness debt, in order to be charged against income, must be in connection with the taxpayer's trade or business. Necessarily there are other justifiable and equitable tax situations where the nonbusiness debt, the proceeds of which were lost in a trade or business, should also be permitted to be charged against income. For instance, a son may go into a business. He has little or inadequate capital to conduct the business. His father either endorses or guarantees his note at the bank to provide funds for the son to go into business, or perhaps the father arranges for the loaning or borrowing of collateral to secure the son's debt at the bank, with the guaranty on the father's part to indemnify the owner of the borrowed collateral against loss. The son embarks in the trade or business, using the borrowed funds.

His business proves unsuccessful, and the bank either requires the father, as guarantor or endorser, to pay the debt or uses the borrowed collateral to pay same, in either of which events the father must respond to the payment of the bad debt, the proceeds of which were used in the son's trade or business.

Regardless of whether it is the father financing the son, standing good for the son's debt, or one friend standing good for another friend's debt, the proceeds of which are lost in a trade or business, it seems to me the bad-debt loss in a trade or business should be properly and justly deductible by the taxpayer who bears the loss and not confined, as subdivision (d) (2) (A) now provides, to a debt created or acquired in connection with a taxpayer's trade or business.

As the definition in subdivision (d) (2) (A) now reads, the taxpayer must lose the money in his own trade or business and not in the trade or business of another. Under the suggested amendment the definition under subdivision (d) (2) (A) would be enlarged so that a nonbusiness debt would be deductible from income where the proceeds of the debt were used in a trade or business and lost, thus creating a bad debt regardless of whether it was taxpayer's trade or business or the trade or business of another, for the main point is, Was the money realized from the bad debt lost in a trade or business, regardless of whether it was taxpayer's trade or business or that of another for which the taxpayer was liable or responsible either as guarantor, endorser, indemnitor, or in some other capacity?

In discussing the above-mentioned amendment with Mr. Stam, I gained the impression he felt that it possessed merit.

The adoption of the specific suggested amendment above mentioned is not important if the principle is taken care of in some other appropriate language and possibly at some other more appropriate place in the definition of nonbusiness debts.

I earnestly submit for the consideration of your committee the suggested enlargement of a nonbusiness debt which may be charged against taxpayer's income so as to permit a taxpayer who sustains a loss in backing another engaged in a trade or business to charge such loss against his income and not be confined to a charge against capital gains which he may or may not have.

Respectfully submitted.

FRED KORTH.

NEW YORK, N. Y. *April 19, 1954.*

MARIETTA RESEARCH & INVESTMENT CO.,
Milwaukee, Wis., April 20, 1954.

Re Revenue Code of 1954 as introduced, section 505 (a) 6 and (a) 7.

Hon. EUGENE D. MILLIKIN,
Finance Committee Chairman,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: We wish to respectfully direct your attention to what we believe are inequitable provisions in section 505 (a) 6 and section 505 (a) 7 of the Revenue Code of 1954 now before the Senate Finance Committee.

The paragraphs referred to stipulate that investments of employees' trusts in real estate or securities (other than certain excluded categories) are to be limited in respect to any one investment or issue to an amount not greater than 5 percent of the value of the total assets of the trust. Presumably this is designed to prevent the exercise of certain forms of control by exempt employees' trusts.

We have no quarrel with this objective. However, in the case of employees' trusts with only a few thousand dollars of assets, of which there are probably a good many in existence, and in which category our particular trust must be classified, a percentage restriction alone definitely hampers the efficacy of an investment program. Diversification is fine in principle but can be carried to extreme. An investment limitation of only a few hundred dollars in any one particular issue can easily nullify investment judgment and prohibit investment in adequate measure in certain situations which from time to time might be particularly attractive.

Therefore it is an earnest plea that the Senate Finance Committee give consideration to the inclusion of an alternative maximum dollar limitation as well as a percentage basis. This would not defeat the purpose of the provision, but would remove the inequity which would now be imposed on small trusts.

Specifically we recommend that the provision be reworded in such a way as to make the limits in section 505 (a) 6 and (a) 7 $5,000 or 5 percent of total assets, whichever is the greater.

To repeat, on behalf of the many other small employees' trusts we respectfully urge serious consideration of this suggested change.

Very truly yours,

MARIETTA RESEARCH & INVESTMENT CO.,
ELGIN E. NARRIN, *Trustee.*
JOHN G. TAYLOR,
Chairman of Employees Committee.

THE PENN MUTUAL LIFE INSURANCE CO.,
THE FREDERICK R. LUTHY AGENCY,
Peoria, Ill., April 19, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: Having studied history of life insurance and its benefits that are set up for protection primarily for those who would suffer financial loss in event of the breadwinner's death, I am both surprised and greatly disturbed by the fact that insurance benefits in pension trust cases are now being considered by your committee to be placed in a category subject to income tax.

Should this take place, a great injustice will be done to widows and children who need this additional security. In addition, they receive it presently at such a nominal cost that it cannot be met elsewhere.

With many thanks for your consideration, I am,

Cordially yours,

KENNETH L. KEIL, *C. L. U.*

GENERAL MILLS, INC.,
Minneapolis, Minn., April 19, 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Finance Committee of the Senate,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: This letter concerns the Revenue Code of 1954 (H. R. 8300). The code as passed by the House represents a tremendous task, and those that have spent long hours in its preparation deserve a great deal of praise.

There are sections in the act which are of concern to our company, and we request that your committee give consideration to their correction.

Section 359 (b) (2) and 359 (c) (1) dealing with corporate acquisition of stock and corporate acquisition of property each contain a rule providing that certain minimum and not more than certain maximum amounts of participating stock must be issued by the corporation acquiring the stock of the other corporation or the property of the transferor corporation if the transaction is to qualify as a tax-exempt transaction.

The experience of our company would indicate that the above type of limiting rule would actually result in less revenue to the Government than would be the case if the rule did not exist.

In 1952 our company acquired the properties of O-Cel-O, Inc., in exchange for common stock. The acquisition qualified as a tax-free transfer under the 1939 code. At the time of the transfer, O-Cel-O, Inc., was in need of additional funds to expand its manufacturing facilities and to increase its working capital. The management of the company had built an enviable business in the 5-year history of the company, but it was their definite conclusion that production would have to be increased to meet sales demands or they would gradually lose their business to severe competition. No increase in production was possible in their then existing plant facilities. The management also felt that common stockholders rightfully deserved a cash dividend, but there was no foreseeable possibility that a dividend could be paid. Because of these facts, the management of O-Cel-O, Inc., negotiated with our company for an exchange of O-Cel-O properties for our stock which was approved by the O-Cel-O, Inc., stockholders.

As a result of this transaction stockholders holding the stock we issued in this transaction have received in approximately 17 months over $260,000 in cash dividends which is ordinary taxable income. The plant has been expanded which we believe has resulted in income to the suppliers and builders, and our company has paid income taxes on the income derived from this business since the acqui-

sition. Salaries and wages of substantially the same group of employees has increased.

If the proposed rule of H. R. 8300 had been in existence, this transaction would not have been possible. O-Cel-O, Inc., was not a public corporation, and therefore merger or consolidation would not have been possible. We would not have been willing to issue approximately eight times the number of shares of our common stock in this transaction as would be required as a minimum by the proposed rule to make the transaction a tax-free corporate acquisitioun of property. O-Cel-O, Inc. stockholders would not consider any deal other than one in which they could continue corporate ownership of participating stock. The principal reason for this attitude was that they wanted to participate in what they felt would be the future growth of the very business they owned and were transferring. They also felt strongly that so long as all they were doing was exchanging a stock certificate in their corporation for a stock certificate in another corporation that they would not pay income taxes in cash on such a transaction. They rightfully considered that they would continue the risk inherent in an equity corporate share after the transaction as existed before the transaction.

If the transaction had not occurred, at the very least, the amount of dividend income would not have been included in taxable income. It is entirely possible that other income would have been denied to the Government's income-tax base if the transaction had failed.

We request that the rules contained in section 359 (b) (2) and 359 (c) (1) be eliminated.

Our company is also concerned about the 85 percent tax assessed against the corporation for redemption of nonparticipating stock within a 10-year period (sec. 309). We have outstanding 5 percent preferred stock currently redeemable at $120 per share. This stock was issued in exchange for 6 percent preferred stock which was originally issued in 1928 and 1929 for money and property. The redemption price of the 5 percent preferred stock was placed higher than the former 6 percent stock as an inducement for the shareholders to exchange the 6 percent stock for the 5 percent stock. This issue of stock is not in any way a device to avoid income taxes. The dividend rate and the redemption price of each issue was necessary to obtain money and property for the company.

We agree with the stated objective of section 309 but believe it should be made applicable only to situations which are designed to result in tax avoidance. We believe the result would be more equitably accomplished by taxing the individual recipient of the nonparticipating stock as a dividend upon his first intervivos transfer of the stock than by placing a penalty tax upon the corporation. If it is not practical to tax the individual then we suggest that publicly held corporations be excluded and make the penalty tax applicable only to redemptions dating from the actual issue date of the stock and not from the arbitrary date of January 1, 1954.

Consideration should also be given to raise the proposed 5 percent premium for redemption of nonparticipating stock issued for securities or property if the penalty tax is to apply to the corporation. We see no reason why the small corporation, if publicly held or not, should be denied the right to raise money for its needs if the market conditions are such that a substantial redemption premium is necessary.

Thank you for giving this your consideration.

Very truly yours,

J. M. BARKER, *Manager of Taxation.*

RIEGELMAN, STRASSER & SPIEGELBERG,
Washington, D. C., April 19, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Our client, the investment firm of Model, Roland & Stone, has recently taken the liberty of forwarding to you a memorandum, suggesting the formation of foreign investment companies. The memorandum explained how such companies would advance the objectives of our Government in the field of foreign economic policy.

Earlier this year Mr. Stam was kind enough to meet with representatives of this firm to discuss the possibility of including in the proposed tax code a pro-

vision to remove the tax disadvantage which currently mitigates against the formation of foreign investment companies. Since then we have been gratified to note that a provision to remove these disadvantages was inserted in H. R. 8300. It is section 853.

Unfortunately, section 853 has been worded in such a manner as to create serious doubt whether the term "taxes paid" can be defined to cover certain provisions of income tax treaties heretofore entered into by the United States, specifically the provisions of article XIII of the treaty with the United Kingdom. We, therefore, respectfully request consideration of an amendment to section 853 stating expressly that the words "taxes paid" include taxes deemed paid under the terms of any treaty heretofore entered into by the United States, as indicated in the enclosed memorandum.

Very truly yours,

RICHARD SCHIFTER.

MEMORANDUM RE TECHNICAL ERROR IN SECTION 853 OF H. R. 8300 PERTAINING TO AVAILABILITY OF FOREIGN TAX CREDITS TO STOCKHOLDERS OF CERTAIN REGULATED INVESTMENT COMPANIES

Section 853 of H. R. 8300 represents an effort to stimulate American investment in foreign countries by making available to stockholders in certain regulated investment companies such credit for foreign taxes as they would receive if they owned foreign securities directly rather than through an intervening corporation. To accomplish this purpose and to encourage the pooling of capital and its investment in foreign securities via regulated investment companies, section 853 in effect provides that a stockholder of such a company may, under certain circumstances, treat as paid by him his proportionate share of any "income, war profits and excess profits taxes described in section 901 (b) (1) (A)" which are "*paid*" by such investment company. [Italic added.]

We respectfully submit that the use of the word "paid" may frustrate the purpose of section 853 by precluding such a company from passing on to its stockholders certain important tax credits which would be available to the stockholders if they owned the corporate portfolio directly. Unless these credits are made available to stockholders the tax burden will prohibit appreciable investment in foreign securities via regulated investment trusts.

The problem is exemplified by a consideration of the United Kingdom income tax. Any United Kingdom corporation which pays a dividend is required to withhold from the gross amount of such dividend and pay over to the Treasury an amount equal to 45 percent thereof. Only the balance of the dividend after deduction of such income tax is paid over to the stockholders. In *Biddle* v. *Commissioner* (302 U. S. 573 (1938)) the Supreme Court held that the recipient of such a dividend could not get a tax credit for the amount of the tax so withheld because the tax was not "paid" by the United States taxpayer as required by section 131 of the Internal Revenue Code. Subsequently article XIII of the income tax treaty between the United Kingdom and the United States corrected this situation by providing that "the recipient of a dividend paid by a corporation which is a resident of the United Kingdom shall be deemed to have paid United Kingdom income tax appropriate to such dividend * * *."

Although as the recipient of a dividend, a regulated investment company like any other holder of stock in a United Kingdom corporation will be deemed to have paid the United Kingdom income tax appropriate thereto and will therefore be entitled to a credit for such tax, a stockholder in such a company might not be able to treat as paid by him his proportionate share of such tax because it might be held that the tax was not paid by the regulated investment company as required by section 853 (a).

We believe that the situation could be clarified, litigation avoided, and the intent of Congress best effected by revising section 853 so that it will clearly provide that a regulated investment company may pass on to its stockholders any credit for taxes which would be available to its stockholders if they held the portfolio of the investment company directly. This can be done by amending the last part of section 853 (a) so that it will read as follows:

"may, for such taxable year, elect the application of this section with respect to income, war profits, and excess-profits taxes described in section 910 (b) (1) (A), which are paid, or which pursuant to any tax treaty between the United States and a foreign country are deemed paid, by the investment company

during such taxable year to foreign countries and possessions of the United States."

We have discussed this problem with some of our clients who are interested in the formation of a regulated investment company which would invest in foreign securities. They have advised us that the formation and success of such a company would be contingent upon an assurance that section 853 would afford to the stockholders of such a company all tax credits they would have if they held foreign securities directly. In their opinion, unless such assurance exists, it will be impossible to attract capital for investment in a foreign investment company.

Council of Kansas City, Mo.

RESOLUTION RELATING TO THE FEDERAL TAX REVISION BILL OF 1954

Whereas, the House of Representatives has included in its revenue revision bill of 1954 (H. R. 8300) a section known as section 274 which denies the right to deduct as a business expense the rents paid by a manufacturing lessee of property from a State or municipality for plants and/or property where the acquisition or improvement of said plants and property are financed by revenue bonds which do not carry the backing of the full faith and credit of the issuing government, and

Whereas section 274 of the revenue revision bill of 1954 is presently before the Senate Finance Committee, and

Whereas the announced purpose of said provision is to prevent municipalities from acquirng property and building factories thereon to attract established industries from other sections of the country, and

Whereas the provision goes far beyond its announced purpose in that it prohibits incidental development of property necessarily held for another public purpose as well as property acquired solely for factory construction, and by failing to define "manufacturing purposes" it invites dangerously broad construction (especially with the accompanying House report which announces it should include any "activities * * * the result of which is to make available for sale an article or product") far beyond the ordinary concept of manufacturing, and

Whereas the provision fails even to accomplish its announced purpose in that it permits the same activities if financed by general obligation bonds, thus placing a premium on a method of financing which may be contrary to the public interest in particular situations, and

Whereas the peripheral development of airports is essential to the efficient and economic operation of American airports, and although prevention of such development is not within the announced objective of said section 274, nevertheless it is effectively circumscribed by such provision; and

Whereas the philosophy of penalizing State and local governments because of disagreement by Congress with their lawful purposes and objectives and techniques is repugnant to the American concept of dual State and national sovereign individuality, free and independent and untrammeled by Federal review and coercion when acting in their legitimate spheres, and constitutes an oppressive and unwarranted interference with local government: Now, therefore, be it

Resolved by the Council of Kansas City, That it is the urgent request of this Council that section 274 of the revenue revision bill of 1954, H. R. 8300, be stricken from said bill and that neither that section nor any other legislation prejudicial to revenue bond financing of airports and appurtenant properties be enacted into law; and be it further

Resolved, That a copy of this resolution be sent to each of the members of the Finance Committee of the United States Senate and to each of the Senators and Representatives of Congress from the State of Missouri.

Authenticated as adopted this April 16, 1954.

W. E. Kemp,
Mayor.
Margaret Strahm,
City Clerk,
Dale M. Gray,
Deputy City Clerk,

YALE LAW JOURNAL,
New Haven, Conn., April 21, 1954.

SENATE FINANCE COMMITTEE,
Elizabeth B. Springer, Clerk,
Senate Office Building, Washington, D. C.

GENTLEMEN: I would like to bring to your attention an inconsistency in the treatment of past service credits in the qualified pension plan sections of the proposed new Internal Revenue Code.

Section 501 (e) (4) (A) provides that neither contributions nor benefits for one employee can be in a higher ratio to compensation (excluding the first $4,000 of compensation) than for any other employee covered by the plan. This means that contributions are controlled by compensation only, and, therefore, that past service crediting no longer will be allowed.

The only way past service crediting might be preserved is by manipulating the definition of compensation in section 501 (e) (4). "Total compensation," as used in section 501 (e) (4), could be read to mean the total of an employee's compensation since joining the company. This interpretation would benefit the employee with longer service by allowing him to participate to the extent of his accumulated compensation; with the sum earned before the inception of the plan being treated as the past service credit. But that reading of the definition of compensation certainly is not apparent on the face of the statute. Indeed it is a most improbable reading. "Total compensation" is used in contradistinction to "basic" compensation. In other words, the code is rather clearly stating that "total" compensation means basic compensation plus bonuses, overtime, etc.—not accumulated compensation.

On the other hand, section 403 (a) (1) deals, to a great extent, with the funding of past service credits. On its face, this subsection appears to reenact section 23 (p) (1) (A) of the old code without substantial change, thereby treating past service crediting as a still usable device. This view is supported by the House report at page A150.

The sections could be rationalized by reading the past service funding provisions to be applicable only to existing plans. However, there is no basis in the statute for reading section 403 (a) (1) so narrowly, and it is questionable that it was intended to be so read. Moreover, in view of the long-acknowledged benefit of past service crediting in pension plans; i. e., the making possible of immediate funding of pensions for older employees, I am not at all sure the drafters of the new code intended to do away with past service credits.

Yours truly,

LEWIS G. COLE.

SQUIRES & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
New York, N. Y., April 20, 1954.

Re H. R. 8300.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

(Attention: Mrs. Elizabeth Springer, Clerk.)

DEAR SIRS: I do not know whether or not in its consideration of H. R. 8300, the proposed Internal Revenue Code of 1954, the Senate Finance Committee is giving consideration to amendments to the Excess Profits Act of 1950, as amended by the 1951 Revenue Act. However, an amendment to section 432 of that act appears in order as a result of its termination in 1953.

The said section 432 IRC, provides for the carry-back for one year, and the carry-forward for 5 years, of any unused excess profits credit. This, according to the report thereon of the Senate Committee at the time of its adoption, would allow the averaging of a period of 7 years and was, at the time, considered more equitable than the World War II law which provided for a 2-year carry-back and a 3-year carry-forward, or an averaging of a period of 5 years.

Since the Excess Profits Act of 1950 was in effect for only 4 years the intent of a 7-year averaging period becomes obsolete, and the limitation of a 1-year carry-back period will in certain cases bar the use of an unused excess profits credit either as a carry-back or a carry-forward.

As an illustration of the inequity of section 432 as it now stands, let us compare two corporations each with an excess profits credit of $50,000 and total net income for the 4 years of $200,000 but varying by years.

A corporation	Net income	Excess-profits credit	Unused excess-profits credit carry-back	Excess-profits tax payable
1950	$75,000	$50,000		$7,500
1951	60,000	50,000		3,000
1952	50,000	50,000		None
1953	15,000	50,000	$35,000	None
Total	200,000			10,500

B corporation	Net income	Excess-profits credit	Unused excess-profits credit carry-forward	Excess-profits tax payable
1950	$15,000	$50,000	$35,000	None
1951	50,000	50,000		None
1952	60,000	50,000	10,000	None
1953	75,000	50,000	25,000	None
Total	200,000			None

A corporation, in an industry experiencing wide fluctuations in income, had an exceptional year in 1950 and has tapered off since, is unable to make use of an unused excess-profits credit for 1953 after having paid $10,500 in excess-profits taxes for the years 1950 and 1951.

B corporation, with the same net income for the years 1950–53 as A corporation, but in reverse order, receives the full benefit of an unused excess-profits credit for 1950 by application of the carryforward privilege and winds up with no excess-profit tax payments.

I believe that this situation particularly affects the relatively small corporations and that the apparent inequity should be corrected by an amendment to section 432.

It is suggested that such an amendment provide for a 3-year carryback period and a 3-year carryforward period of an unused excess-profits credit. This would permit an average of the 4 years that the excess profits were in effect and would give taxpayers with unused excess-profits credits in the late years the same opportunities to make use thereof as those with similar credits in the earlier years.

Very truly yours,

E. W. BREITUNG.

ROSS & GOLDMAN,
San Francisco, April 20, 1954.

SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: We have reviewed the proposed changes in the revenue revision bill of 1954 which might materially affect existing or future insurance brokerage partnerships. We are particularly referring to the treatment of payments to a retiring partner or a deceased partner's heirs.

We would like to go on record with you that we consider this form of legislation unfair and detrimental to insurance brokerage partnerships and wish to express our disapproval of the proposed changes.

Very truly yours,

ROSS & GOLDMAN.
HERBERT I. ROSS.

WISE, BAKER & CO.,
Waterloo, Iowa, April 19, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SIR: The proposed revenue act of 1954 which is now in your Senate Finance Committee and is known as H. R. 8300 has one very alarming factor to me in it. This is technical in nature but it so happens to vitally affect all those who must work with taxes on a day-to-day basis. I have no objection to a complete revision of the Internal Revenue Code, but do have vast objection to a

wholesale renumbering of the Internal Revenue Code sections. The vocabulary of taxmen in the United States today is geared to Internal Revenue Code sections and has been geared to the same sections for the past 15 years. Our libraries (which are very costly), texbooks, prior technical writings, notebooks we ourselves have collected, etc., are all geared and refer to these code sections.

Now, for no practical reason it is proposed to rearrange the code sections. I have done some research on the matter and I find in general it would be just as practical to amend or add to the present code sections as it would be a renumber the entire Internal Revenue Code. For instance, when speaking of a certain type of distribution we refer to it as a code section 112 b6 distribution. This same type of distribution will be in the proposed new law but will undoubtedly be called, for instance, section 324. This will mean that we will have to have expensive correlators and revise our entire libraries because of, in our opinion, a rather foolish change. In addition it means that for many years we will have to work with two sets of code sections. It is hard enough to work with 10,000 Internal Revenue Code sections at the present time without adding an additional 10,000 to it.

I would further like to call your attention to the new jurat proposed by Representative Mills, which would place a greater degree of responsibility to the preparer of an income-tax return. This system has been used in the United Kingdom for many years and has been highly satisfactory. It would give the Internal Revenue Service a guide and should materially assist them in deciding which returns to audit.

For many years we have needed an income-tax deadline further advanced than March 15. I heartily endorse the new April 15 deadline for individuals but believe that the same deadline should apply to corporations. It will be noted that H. R. 8300 applies only to individuals and partnerships and not to corporations. In many cases the corporate return has a greater need for a longer filing period than the individual return. You must remember that only 75 days including Sundays and holidays, elapses between the first of the year and March 15.

Any consideration in committee that you can give to my suggestions would be greatly appreciated.

Very truly yours,

HOMER E. WISE.

ROYAL, IOWA, *April 15, 1954*.

My name is Hugh D. Hale, of Royal, Iowa, a member of the tax committee of the Grain and Feed Dealers National Association with offices in St. Louis, Mo., and Washington, D. C. I would like to ask the Senate Finance Committee the following questions. (I feel that the Federal Government has been handling the tax setup in an unfair and unequitable basis and has only served to drive the small private businessman out of the grain and feed business.)

1. Why does the Treasury Department insist that a corporation report all dividend payments of $10 or more, while it favors cooperatives by allowing them to report only dividend payments of $100 or more?

2. Why does the Federal revenue blank, form 1040 under schedule A, very specifically and with a special space insist that the recipient of a corporation dividend list each one separately, but it favors cooperatives under form 1040F by allowing only one line to report a total lump sum of all dividends received? Why should they not be itemized because a majority of farmers deal through 3 and 4 cooperatives? Furthermore, form 1040F gives a choice "use this line, if not reported elsewhere."

Three years ago the revenue staff agreed this change was necessary and was being made, but to date the blanks have not been changed.

3. Why does the Federal Government not get a Supreme Court ruling on the controversial question: "Is a Federal income tax due on a deferred cooperative dividend when it is allocated, or when the dividend is paid in cash?"

This question is so controversial that the Des Moines (Iowa) Register, under date of January 3, 1954, advised its readers "unless a considerable amount of tax is involved it is the writer's suggestion that you report your patronage dividends in line with Internal Revenue Service requirements."

This newspaper article was written, due to the fact the Farmers Grain Dealers Association of Iowa on October 28, 1953, won their suit against the Federal Government in district court. But to date, the Federal Government has taken no action to get a Supreme Court decision.

Why should cooperatives have these advantages? The big cooperatives can pyramid their business through each other and gain considerable tax advantage over private business by deferring patronage dividends. (And if you have made a study of this problem you understand what I mean by pyramiding deferred dividends.)

As a taxpayer, why am I not entitled to give my customers just as good facilities and as good service as the farmer receives who trades with a cooperative? Why should the cooperative have a tax advantage over me when he is my competitor and is doing exactly the same kind of business? In my territory, the farmer who trades exclusively with a cooperative doesn't have any higher standard of living than the farmer who has done all his trading with me. This tax advantage at the grassroots doesn't make one bit of difference in the farmer's standard of living, but it does put me at a considerable disadvantage as to the facilities and services I can offer my customers. For example, in one particular year my cooperative competitor made $82,000 and paid a Federal income tax of $4,000, keeping the balance as deferred dividends, which he used to expand his business to compete against me. While I, as a private taxpaying citizen, in making $82,000 (filing as a married person with one exemption) would have paid Federal income tax of $52,570. Do you see the disadvantage it put me in in providing facilities to compete with my competitor? Why should my customers be penalized because I cannot provide these facilities and services because of these tax exemptions?

The Treasury Department consoles me by saying I can pay a patronage dividend to my customers, exactly the same as a cooperative, and not be subject to Federal income tax. But this is a mere play on words. as this is only a Treasury ruling and they have the right to change their mind at any time. But in the case of the cooperative this permission has been given them by an act of Congress, and can only be changed by an act of Congress.

HUGH D. HALE,
Member, Tax Committee, The Grain and Feed Dealers National Association.

MASONITE CORP.,
Chicago 2, Ill., April 21, 1954.

Re capital gains treatment accorded income from cutting or disposal of timber under sections 631 and 272 of H. R. 8300.

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

DEAR SIR: As a forest owner with holdings in Mississippi and California, we respectfully protest the proposed changes in section 117 (K) of the present Internal Revenue Code. Our reasons for protesting these proposed changes are set forth briefly in the attached copy of a letter that we have directed to the Senators of this State.

We respectfully request that you give serious consideration to suggesting to your committee that the proposed changes in section 117 (K) as set forth in H. R. 8300 be not enacted by striking out references to timber in section 272 and by amending section 631 so it will retain the provisions of section 117 (K) of the present Internal Revenue Code insofar as they relate to timber.

Yours very truly,

BEN O. ANDERSON, *Treasurer.*

APRIL 21, 1954.

Re capital gains treatment accorded income from the cutting or disposal of timber under sections 631 and 272 of H. R. 8300.

Hon. PAUL H. DOUGLAS,
Washington, D. C.

DEAR SIR: The revenue revision bill recently passed by the House of Representatives and now under consideration in the Senate Finance Committee will change the capital gains provision of the present Federal income tax law applicable to timber and lessen the benefits of that provision, increase the taxes on income from timber and create complicated bookkeeping and accounting problems.

Briefly, this change would require that we, as a taxpayer, charge expenses such as taxes, interest, forest protection costs, and all other expenses attributable to the timber cut against any capital gains under section 117 (K) of the Internal

Revenue Code. The right to charge these ordinary expenses against ordinary income as at present would be denied.

We feel that the adoption of the proposed changes in capital gains tax on timber would discriminate against us as timber owners as compared to other taxpayers having capital gains. It would create a conflict between ourselves and the Department of Internal Revenue as to the proper allocation of expenses between those chargeable against ordinary income and those chargeable against capital gains; and would discourage the good forestry program that we, as forest owners, have adopted under the incentive of section 117 (K).

We respectfully request that you give serious consideration as to the effect of this proposed change in the Internal Revenue Code on us and other forest owners and that you urge that the Senate Committee on Finance amend H. R. 8300 by striking out references to timber in section 272 and by amending section 631 so it will retain the provisions of section 117 (K) of the present Internal Revenue Code insofar as they relate to timber.

Yours very truly,

MASONITE CORP.,
BEN O. ANDERSON, *Treasurer.*

APRIL 21, 1954.

Re capital gains treatment accorded income from the cutting or disposal of timber under sections 631 and 272 of H. R. 8300

Hon. EVERETT M. DIRKSEN,
Washington, D. C.

DEAR SIR: The revenue revision bill recently passed by the House of Representatives and now under consideration in the Senate Finance Committee will change the capital gains provision of the present Federal income tax law applicable to timber and lessen the benefits of that provision, increase the taxes on income from timber and create complicated bookkeeping and accounting problems.

Briefly, this change would require that we as a taxpayer charge expenses such as taxes, interest, forest protection costs, and all other expenses attributable to the timber cut against any capital gains under section 117 (k) of the Internal Revenue Code. The right to charge these ordinary expenses against ordinary income as at present would be denied.

We feel that the adoption of the proposed changes in capital gains tax on timber would discriminate against us as timber owners as compared to other taxpayers having capital gains It would create a conflict between ourselves and the Department of Internal Revenue as to the proper allocation of expenses between those chargeable against ordinary income and those chargeable against capital gains; and would discourage the good forestry program that we, as forest owners, have adopted under the incentive of section 117 (k).

We respectfully request that you give serious consideration as to the effect of this proposed change in the Internal Revenue Code on us and other forest owners and that you urge that the Senate Committee on Finance amend H. R. 8300 by striking out references to timber in section 272 and by amending section 631 so it will retain the provisions of section 117 (k) of the present Internal Revenue Code insofar as they relate to timber.

Yours very truly,

MASONITE CORP.,
BEN O. ANDERSON, *Treasurer.*

COLLINS PINE CO.,
Portland 5, Oreg., April 21, 1954.

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

DEAR SIR: In response to your recent suggestion as chairman of the Senate Finance Committee that persons desiring to present revisions of H R. 8300 do so by writing the committee, I wish to make the following suggestions for revision of sections 272 and 631 of H. R. 8300. These sections amend section 117 (k) of the present code. Although they were adopted to afford tax relief to owners of coal, they relate to timber as well as coal and penalize timber owners.

I have been furnished with a copy of the proposed revision of sections 272 and 631 of H. R. 8300 submitted to the Senate Finance Committee by the Forest Industries Committee on Timber Valuation and Taxation. I am fully in accord

with the revisions desired by the committee, and strongly urge that they be adopted by the Senate Finance Committee.

The revisions proposed by the Forest Industries Committee do not, however, take care of an inequitable discrimination which has resulted from the Treasury Department's interpretation of section 117 (k) (2) with respect to the date of disposal of timber. This discrimination can be corrected by an amendment of section 117 (k) (2) (or of section 631 of H. R. 8300) to provide that the date of disposal of timber is the date the timber is cut. The necessity for such a provision is explained below:

Date of disposal requirement

In Oregon and elsewhere the form of timber sale contract which is commonly used and which most clearly falls within the statutory definition in section 117 (k) (2) is a timber-cutting agreement by which title normally passes to the vendee when the timber is cut and under which the risk of loss to the timber from fire, insect infestation and other perils remains with the owner-seller until the timber is severed. The Treasury Department in its regulations (sec. 39.117–(k), (b), regulations 118) has taken the position that the disposal contemplated by the statute occurs on the date of the contract rather than on the date of the cutting of the timber, when title and the risk of loss on the timber actually pass under cutting contracts of the type described above.

Effect of present interpretation of "date of disposal" requirement on subsequent transferees of the timber

There are many instances in which timber is sold under cutting contracts running for 5 to 20 or more years, with the stumpage price being related to some variable such as the index price of lumber or the current price of logs. During the period of cutting, the timber subject to the contract is frequently transferred to a new owner through sale, or distribution in liquidation of a corporation, or transmission on death, or by gift. In some instances the transfer is voluntary; in others it is involuntary. Under the Treasury's view that section 117 (k) (2) can be availed of only by an owner who held the timber for more than 6 months prior to the date of the contract, all of the transferees of the timber in these situations will be barred from reporting gain under section 117 (k) (2) even though they may in fact be selling timber from the lands for many years.

The fact is that under court decisions applying the law prior to enactment of section 117 (k) (2) transferees of timberlands subject to a cutting contract were permitted to use the capital gains provisions of the code in reporting their gain from timber cut after they had held the timber for the prescribed holding period. As interpreted by the Treasury Department, therefore, section 117 (k) (2) (and the present wording of sec. 631 of H. R. 8300) discriminates against and substantially worsens the position of such transferees.

Legislative remedy with respect to date of disposal of timber

There is a simple legislative remedy for the inequitable and discriminatory treatment which is accorded one group of timber owners as described above. In whatever from section 117 (k) (2) is enacted in the new Revenue Act of 1954, there should be inserted a new sentence providing:

"The date of disposal of such timber shall be deemed to be the date such timber is cut."

As I have said above, this letter is writen in response to your suggestion that proposals for revisions of H. R. 8300 be submitted in writing to the Senate Finance Committee in lieu of an oral presentation. I very much appreciate the opportunity you have granted taxpayers to make such proposals, and I urge that in connection with your committee's revisions of section 631 of H. R. 8300 the amendment suggested above be inserted.

Very truly yours,

TRUMAN W. COLLINS.

P. S.—In the alternative an amendment by use of a parenthetical phrase as shown on the attached exhibit A may be substituted for the sentence suggested above.—T. W. C.

EXHIBIT A

Proposed revision of first sentence of section 117 (k) (2) to refer to date of disposal in the event coal is eliminated from (k) (2):

"In the case of the disposal of timber held for more than 6 months prior to such disposal (disposal being deemed to occur when the timber is cut), by the

owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber."

OPPENHEIMER, HODGSON, BROWN, BAER & WOLFF,
St. Paul, Minn., April 21, 1954.

Re H. R. 8300, subtitle A

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D. C.

DEAR SIRS: as a full-time law student and hence one theoretically soon to be benefited by the provisions of the new Internal Revenue Code of 1954, I read carefully section 151 of part V, which deals with additional income-tax exemptions for student dependents.

Although possibly an oversight on the part of the drafters of the bill, and although clearly an improvement over the present Internal Revenue Code in regard to education, section 151 seems somewhat inequitable in that it provides benefits only to those parents who are financially capable of providing more than half of their child's support while he is attending school, and in that it provides no benefits whatsoever to the child who is earning his own way through school.

Thus, a parent in a higher income bracket who can afford to subsidize his child's school expenses, for example, would be entitled to an additional exemption; whereas, the parent in a lower income bracket who may be paying proportionately more from his income (than the wealthier parent) for the education of his child, but less than half of the child's expenses, would not be entitled to the exemption. Nor would the student from the lower income family who is forced to earn his own way with no help at all from his parents be benefited in any way; he would have the same $600 individual exemption that he would have had under the old code.

I would suggest that if the purpose of the additional exemption is to benefit per se the parent who still has children in school, then this new exemption should be extended to all parents who have children in school (under the provisions of sec. 151, par. (e) (4)), and not just to the wealthier ones.

An effective way to accomplish this end might be to exempt student-dependents from the restrictions of section 152, paragraph (a), and to make the exemption in section 151, paragraph (1) (B) (ii), universally applicable regardless of the percentage of the student's support contributed by his parent(s).

On the other hand, if the purpose of paragraph (1) (B) (ii) of section 151 is rather to support and encourage education per se, a more equitable way to accomplish this result would be to increase benefits not only to those fortunate individuals whose parents can afford to continue to support them in their last years of school, but also to provide additional benefits to students who must earn their own way in order to continue their education.

If the latter is the case, then I would recommend that the committee consider amending the new bill to provide a second exemption, in addition to the present $600 individual exemption, for students who do not receive more than half of their support from their parents—in order to keep students from lower income families on an equal footing with those from higher income families.

Otherwise, I am convinced that the new bill will produce grave inequalities in this respect; since from my own limited experience both as a student and as a former member of several national student organizations, I would estimate that nearly one-third (or more) of the students in institutions of higher education in this country today do not receive more than half of their total support from their parents.

While I trust that you will forgive me for my critcisms, I hope that you will find it possible to give serious consideration to the suggestions I have made.

Respectfully yours,

BERNARD V. PARRETTE.

PACKARD MOTOR CAR CO.,
Detroit 32, Mich., April 20, 1954.

ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: We have gone over H. R. 8300, the proposed Internal Revenue Code of 1954 and feel that except for a few technical amendments which should be made, that the code provides for a number of corrections of inequities with which the taxpayers have been burdened for a number of years.

In our opinion the most important technical change which should be made to the bill involves depreciation.

DEPRECIATION

In order to reduce the number of disputes as to the useful life of capital assets which had reached such a volume as to seriously affect the operations of the Tax Court and the appellate staff of the Internal Revenue Service, the Commissioner after much consideration issued mimeograph 183 and circular 144 under date of May 11, 1953, containing a statement of policy, with respect to depreciation adjustments, under which revenue empolyees shall prepare adjustments in the depreciation deduction only where there is a clear and convincing basis for a change. It was stated in the mimeograph that it was to "be applied to give effect to its principal purpose of reducting controversies with respect to depreciation."

This policy has done much to accomplish its purpose considering the short time since its publication.

Section 167 (e) of the Revenue Code of 1954 nullifies this policy by providing that if the useful life of any property as determined to be appropriate by the Secretary differs by more than 10 percent from that used by the taxpayer, the service shall propose a change.

A 10 percent margin for differences in opinions with respect to anything as indeterminable as the useful life of property is so small as to render it entirely ineffective.

Useful life of property is affected by obsolescence, maintenance, whims of management, business conditions, and many other factors and any determination made of such useful life is at best an informed judgment.

It is therefore strongly recommended that section 167 (e) (1) be deleted, or if not, at least amendment by substituting one of the following:

"(1) The useful life of any property as used by the taxpayer shall generally not be disturbed and the Secretary shall propose adjustments in the depreciation deduction only where there is a clear and convincing basis for a change." This would coincide with the announced policy of the Service as contained in mimeograph 183, or

"(1) Unless the useful life of any property, on which the rate of depreciation is based, determined to be appropriate by the Secretary or his delegate, differs substantially from the useful life used by the taxpayer, the rate for such property for such taxable year shall be the rate used by the taxpayer."

This would coincide with the statement contained in IR Bulletin No. 144.

Yours very truly,

R. E. BRYAR,
Manager, Tax and Property Department.

UNITED MACHINERY & TOOL CORP.,
Worcester, Mass., April 21, 1954.

MRS. ELIZABETH SPRINGER,
Chief Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR MRS. SPRINGER: We are writing to you in regard to the 1954 Internal Revenue Code, House bill H. R. 8300, specifically with respect to section 167, having to do with depreciation.

We feel that this depreciation allowance should be applicable to used and rebuilt machine tools as well as new, as the majority of the several thousands of users of equipment cannot afford to purchase only new. We believe that they should have the same treatment as the large users, and not be handicapped by the enactment of this bill. This, as it is now, is unfair to small and medium business and favors only the large.

We also feel that if this is enacted it will depress the markets and devalue all of the equipment now in use. We therefore request your assistance in the above matter.

Respectfully yours,

DAVID L. HEIMAN, *President.*

SYRACUSE 2, N. Y., *April 21 1954.*

Re H. R. 8300, sections 163, 275, and 312.

ELIZABETH B. SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR MADAM: This letter is in particular reference to the provisions of subdivision (c) of section 312 of the Internal Revenue Code of 1954 as contained in H. R. 8300. The content of this subdivision is particularly important because of its effect through subdivision (d) of section 312 and section 275 upon possible deductions under section 163 for interest paid.

As this section is presently drafted, I do not believe that it is humanly possible to tell exactly what it means; I do not believe that it will be adequate to accomplish the purposes which I assume to have been in the minds of its framers, and I do believe that it may have consequences which were neither contemplated nor are desired or desirable.

I will consider first subdivision (c). It defines "securities" as "* * * an instrument * * * which, in the case of obligations held by persons who together own 25 percent or more of the participating stock, is not subordinated to the claims of trade creditors generally;".

This portion of the definition could be construed in at least three different ways, as follows:

1. The instruments under scrutiny could be considered as a class and if, among the holders thereof, there were persons who owned 25 percent or more of the participating stock, then the instruments would fail to qualify.

2. If, among the holders of the instruments under scrutiny, there could be found persons owning 25 percent or more of the participating stock, then the aggregate of the instruments so owned would not be classed as securities, while other similar instruments owned by other persons would be so classified.

3. Each instrument could be separately considered to determine whether it was owned by a person or persons owning more than 25 percent of the participating stock, and if it were not, it could meet the test of being a "security."

I take it that the object of these related sections is to prevent the deduction by corporations of distributions to insiders under the guise of purported interest which is deductible, amounts which actually should be considered a return upon capital. To accomplish this end, however, the phraseology is particularly poor in that insiders in closely held corporations can very simply make arrangements among themselves which do not involve the use of "instruments." It is for this reason that I say the sections involved will fail to accomplish their apparently intended results.

Many corporations, not particularly closely held, have employed as a perfectly legitimate means of raising capital the practice of issuing debentures. These, in many cases, have been sold through regular investment banking channels and may or may not, either at the time of issuance or at some other time, find their way into the hands of those who also own participating stock. Under the section as drafted, a great variety of results could result to any such corporation, depending in large part, of course, upon what the definition was determined to mean in the first place, but, additionally, upon the changing circumstances beyond the corporation's control which would arise if participating stockholders were to buy more debentures, sell the debentures that they had, were to buy more stock, or sell stock that they had. No corporation would ever be able to determine whether and to what extent debenture expense was deductible by it. This, of course, is made increasingly true by the application of section 311 to the situation, which injects factual matters as to which the corporation could have no actual knowledge.

Turning to subdivision (d), it again is limited by its terms to "an instrument." Included are all such known generally as corporate stock or securities, except participating stock as above described in subdivision (b), and securities as above described in subdivision (c). Notes are not included which, of course, invites the always troublesome question of which notes or debentures are of sufficient

solemnity to be known generally as "securities." Included apparently would be secured corporate bonds.

Section 275 says in effect that payments made on account of nonparticipating stock, as defined in subdivision (d) of section 312, are not deductible. It seems obvious that, under the sections as drafted, it may well be that many corporations may be deprived of legitimate deductions, whereas the attempt to reach distributions made to insiders in close corporations may be wholly unsuccessful.

Very truly yours,

CALEB CANDEE BROWN, Jr.

TSUKIYAMA & YAMAGUCHI,
ATTORNEYS AT LAW,
Honolulu 13, T. H., April 21, 1954.

HON. EUGENE D. MILLIKIN, AND MEMBERS OF THE FINANCE COMMITTEE,
United States Senate, Washington, D. C.

SIRS: Information has been only recently received by those who are engaged in the sake industry to the effect that the revised Internal Revenue Code as recommended by the House Committee on Ways and Means is now being considered by the Senate Finance Committee. It is our understanding that under the proposed revision, sake will be classed and taxed as wine. This means that manufacturers of sake would hereafter have to qualify as bonded wine cellars rather than as breweries. It also means that the tax on sake would be 17 cents per gallon (15 cents after April 1, 1954) if the alcohol content is not more than 14 percent by volume, and 67 cents per gallon (60 cents after April 1, 1954) if the alcohol content is more than 14 percent by volume. Sake normally contains 16 to 18 percent.

Heretofore sake has been classed for many years as a "fermented malt liquor" under the Internal Revenue Code and placed in the same category as beer. The tax rate has been $9 per barrel of 31 gallons or approximately 29 cents per gallon.

It may be of interest to the members of the committee that in the United States sake is being produced only in the Territory of Hawaii. One or two plants used to operate on the mainland but they have been closed. There are at the present time only three sake breweries in Hawaii, namely, Honolulu Sake Brewery & Ice Co., Ltd.; Fuji Sake Brewing Co., Ltd.; Nichibei Shuzo Kabushiki Kaisha, Ltd.

Sake, as the members of the committee know, is peculiarly a Japanese alcoholic beverage. The industry has survived in Hawaii only because some of the Japanese people of the older generation continue to use it. Prior to World War II, the industry flourished. But when every plant ceased operation during the war, the sake users all turned to hard liquor and beer. Although the sake plants resumed operation after the war, a large number of the former sake users did not return to the use of the beverage. As the records of each of the three plants will show, the volume of sake produced and sold has been and is still falling year by year.

It is the foregoing situation, together with the lack of persons interested in or concerned with the industry on the mainland and the absence of representation in Washington, that has kept the local sake breweries uninformed about the proposed revision in question. Having been recently apprised of the fact that your hearings are scheduled to close on April 23, we are resorting to this means posthaste to appeal to your committee to continue sake in the same category as beer for the purpose of the Internal Revenue Code.

We understand that the House has approved excise tax reductions on luxuries. Unlike hard liquor, sake is generally consumed by the Japanese people together with their meals and in connection with wedding receptions and other festivities. The dinner table of a sugar or pineapple plantation laborer in Hawaii is not complete without the use of sake. To him sake is not a luxury but a portion of his food. The manufacturers of sake in Hawaii do not wish to increase their respective prices, nor can the consumer afford to pay more. A jump in the tax from 29 cents per gallon to 60 cents or an increase of 31 cents will perforce result in higher prices. This will not only work a hardship on the average consumers, who are generally of the laboring class, but force many of them to change to other lower priced alcoholic beverage. Under such circumstances, it is apparent that the sake industry will eventually collapse, for all three of the existing sake plants are even now exerting every effort to "hold the line."

In evidencing the sharp drop in the sake business from the prewar years to the present time, may we use as a yardstick the following record of Federal taxes paid on sake covering, for the purpose of comparison, the years 1940 and 1953:

Honolulu Sake Brewery & Ice Co., Ltd.:	
Federal tax on sake paid in 1940	$40, 805. 01
Federal tax on sake paid in 1953	16, 391. 30
Nichibei Shuzo Kabushiki Kaisha, Ltd.:	
Federal tax on sake paid in 1940	49, 255. 77
Federal tax on sake paid in 1953	5, 615. 13

Moreover, the following data are also significant:

	Gallons
Honolulu Sake Brewery & Ice Co., Ltd.:	
1940 sale of sake	228, 589
1953 sale of sake	58, 614
Nichibei Shuzo Kabushiki Kaisha, Ltd.:	
1940 sale of sake	271, 339
1953 sale of sake	16, 546

Honolulu Sake Brewery & Ice Co., Ltd., is capitalized at $350,000. Its prewar consumer's price was $1.80 per gallon. On account of the progressive increases in the costs of labor and materials, the current price per gallon is $5.50. Nichibei Shuzo Kabushiki Kaisha, Ltd., is capitalized at $250,000. Its prewar consumer's price was $1.95 per gallon and the current price is $4.90 per gallon.

Sake, like beer, is brewed. They are both fermented malt liquors. In sake, rice is fermented as barley is fermented in beer. Sake plants are called breweries. So are the beer plants. The process of producing wine is unlike that of producing sake. Wine is not brewed. A wine plant is referred to as a winery. Presumably, such consideration was originally given in joining beer and sake in the same category under the Internal Revenue Code.

On account of the limited class of consumers, the sake industry in the United States may be considered unique and its earning power is correspondingly limited. The respective business conditions of the three remaining sake breweries for the year 1953 were such that had the proposed new tax rate on sake been then effective, the profits of each would have been wiped out. The management of each brewery is apprehensive of the fact that in order to realize some profit, the proposal to tax sake at the higher rate applicable to wine would inevitably lead to higher sales prices. This would invariably reduce the volume of consumption and inflict economic disaster upon the sake industry. At a time when our Congress is manifesting a definite inclination to reduce taxes in other respects, it would appear inconsonant to place sake in a new and unprecedented tax category to the detriment of both industry and consumer. If timely representation had been made before the House Ways and Means Committee, it is probable that sake would have been allowed to remain in the original tax classification.

The Senate Finance Committee is therefore respectfully requested to amend the House version to the end that sake may, as heretofore, be taxed at the same rate as beer.

Respectfully yours,

HONOLULU SAKE BREWERY & ICE CO., LTD.,
NICIBEI SHUZO KABUSHIKI KAISHA, LTD.,
By WILFRED C. TSUKIYAMA, *Their Attorney.*

FUJI SAKE BREWING CO., LTD.,
Honolulu, T. H., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee, United States Senate,
Washington, D. C.

DEAR SIR: We are informed that a bill is now before your committee, which classes and taxes sake as wine. Sake contains more than 14 percent of alcohol by volume, and consequently under the bill it will be taxed at the rate of 60 cents per gallon.

Heretofore sake has always been taxed at the same rate as beer. The present rate of tax on beer is $9 per barrel of 31 gallons, or approximately 29 cents per gallon.

Thus under the bill, tax on sake will be increased 31 cents per gallon.

We are encountering difficulty in selling sake even under the present tax rate and the increase in tax and the consequent increase in price will no doubt result in further curtailment of consumption. In 1939, a typical prewar year, we sold 237,159 gallons of sake, while in 1953 we sold only 88,531 gallons.

Under the circumstance set forth above, any increase in tax on sake will place the industry in a very difficult position. We therefore respectfully request that sake be taxed as beer, as is the current practice. Sake is taxed as beer under the existing laws, and has always heretofore been so taxed, because the process of manufacture of sake is similar to that of beer.

Yours very truly,

T. SUZUKI, *Vice President.*

HONOLULU, *April 21, 1954.*

Senator EUGENE MILLIKIN,
United States Senate, Washington, D. C.:

Re revision of Internal Revenue Code applicable to tax on sake all sake breweries in Hawaii have just forwarded by airmail joint request for consideration by Senate Finance Committee.

HONOLULU SAKE BREWERY,
FUJI SAKE BREWERY,
NICHIBIE SAKE BREWERY.

COLUMBUS, OHIO, *April 22, 1954.*

Hon. EUGENE D. MILLIKIN,
United States Senate,
Washington, D. C.

SIR: At a meeting held April 22, 1954, the patent law committee of the Columbus Bar Association by a unanimous vote of those present, constituting a quorum, adopted the following resolution:

"*Resolved*, That this committee is opposed to the tax revision bill, H. R. 8300, section 1235, because it is believed that the 5-year period specified therein should be a period of 17 years in the case of a patent, corresponding to the life of a patent, because it is believed that all inventions should be included regardless of whether patent applications have been filed or patents have been obtained on them, and because it is believed that the capital gains treatment should not be limited to those persons whose efforts created the property."

Will you please bring this resolution to the attention of the Senate Finance Committee.

Very truly yours,

PHILIP M. DUNSON,
Secretary, Patent Committee, Columbus Bar Association.

W. H. BRADY CO.,
Milwaukee 12, Wis., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: It has been called to my attention that the present tax revision bill H. R. 8300 includes a section 1235, dealing with the transfer of patents by inventors.

The proposed legislation is of interest to me. As presently drafted, section 1235 prohibits parties defined as "related persons" from enjoying the benefits of the act. In reviewing the given definitions for "related persons" it is clear to me that a very arbitrary stand is being taken in excluding this group of individuals from the benefits of section 1235. As a consequence I wish to make this written statement, to be considered by those who are to study and draft revisions to the present language of the bill.

"Related persons" are defined to include descendants, ancestors, and spouse, as well as an individual and a corporation in which the individual owns, directly or indirectly, over 50 percent of the stock. By definition stock owned by members of the family is considered as owned by the individual. That is true, even though the stock may be exercised contrary to the individual's interest.

I immediately question why this group of "related persons" is excluded from claiming benefits of section 1235. I am informed that the reason is that there

is a fear that abuses may arise in transactions between these "related persons," due to their close relationship, and that the transactions may not be bona fide, as distinguished from transactions with strangers.

I question whether this supposed lack of a bona fide transaction is usually the fact, or even the fact in a respectable number of instances. If not, and if the legislators are not sure, then this shotgun approach to possible abuse should be soundly condemned. Let us not throw away all the apples in a basket because we suspect 1 or 2 of being rotten.

Where several parties, relatives or not, have financial interests in a business and work closely with one another they each watch and protect their personal financial interest. If one of the parties has something to contribute the others are not willing to allow the business to purchase the item at an inflated price, or even a value in excess of its true worth. The sale of the item, in this case a patent, is closely surveyed by each party. This becomes a true business transaction and often as difficult for the parties to agree upon as when dealing with a stranger.

To my knowledge the above paragraph illustrates the typical, not the abnormal. The present exclusion of "related persons" will cover many of these situations. It makes the honest suffer for the abuses of a few. A tax-revision bill should strive for equal treatment. The present exclusion of "related persons" is such a broad swath through the inventive path as to bear no true relation to the problem of abuse.

To weed out abuses, it would seem better to test each transaction by determining whether the consideration passing between the parties is substantially the same as would be the result of a transaction with a complete stranger. With such a test, section 1235 may then be applicable to all inventors, not just those who free lance. I ask that this view of mine be given consideration. The present proposal appears in need of change.

It is not just a few that will be affected by this problem of "related parties." Of the inventors in this country that dispose of patents, other than as employees paid to invent, a very large proportion is undoubtedly composed of those whose work centers about business enterprises with relatives and in which large shares of stock are held by relatives. These inventors cannot dispose of patents to other parties, since such other parties are nearly always competitors.

Therefore, the problem I am discussing is of substantial magnitude. It deserves attention, and I urge that other means, such as set forth herein, be adopted to weed out abuse, rather than the approach presently incorporated in section 1235.

Very truly yours,

FREDERICK W. BRADY.

ROLLER SKATING RINK OPERATORS ASSOCIATION OF AMERICA,
Detroit, Mich., April 22, 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Room 315, Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: We have been informed that the Senate Finance Committee will soon conduct hearings regarding H. R. 8300, which is, of course, the Revised Internal Revenue Code.

Due to the fact that on page 445, chapter 33, subchapter (a), section 4233, paragraph 4, of H. R. 8300 appears in its entirely explicit exemption from admissions taxes in behalf of municipal operations of skating rinks and swimming pools, we beg of you to give utmost consideration to the damage which this minor factor in our tax structure has created since 1951 when it was instituted.

Congressman Karl C. King of Pennsylvania was very kind in introducing during the first session of the present Congress, H. R. 3421, a copy of which we attach to this letter for your records. Unfortunately, due to the tremendous amount of tax legislation which beset the House Ways and Means Committee upon that occasion, his bill was set aside and we were included in the general admissions tax reduction which is now in effect.

We would like to point out that in practically no other field whatever is there a discriminatory clause now existing in the tax structure such as the one which we submit to you for your consideration. The municipal operations have paid utterly no tax whatever since 1951, while our small business have found conditions extremely difficult. The irksome condition of having this tax differential hanging over our heads, so to speak, does not seem to be quite within

the fair play attitude so nearly always prevalent in United States tax policies. Were, God forbid, we to be faced with an initial emergency tomorrow which would require the application of strong admissions taxes once again—private enterprise would bear the load immediately but the admissions tax inequity would immediately be prominent again because municipal operations would be tax free, private enterprise bearing the full load. Of course, I realize that your committee is burdened with tremendous problems. You no doubt will understand that as long as the admissions tax inequity exists, we must make known our case because a basic American principle is involved. I refer to the widely known quotation, "equal taxation under law."

To finally sum up the situation we find that the tax differential has induced the municipalities to enter private enterprise by converting public buildings and erecting public buildings with tax moneys for the specific conduction of skating and swimming in direct opposition to existing private enterprise in both fields and, furthermore, these municipalities also have the privilege of licensing their opposition (our private small business enterprises).

We appeal to your sense of fair play and your knowledge of business competition in our free enterprise United States. Thank you.

Sincerely,

R. D. Martin,
Secretary-Treasurer, RSROA of America.

[H. R. 3421, 83d Cong., 1st sess.]

A BILL To amend section 1701 (d) of the Internal Revenue Code to provide that the tax on admissions shall not apply in the case of admissions to privately operated swimming pools, skating rinks, and other places providing facilities for physical exercise.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1701 (d) of the Internal Revenue Code (relating to exemptions from the admissions tax in the case of municipal swimming pools, etc.) is hereby amended to real as follows:

"(d) Swimming Pools, Etc.—Any admissions to swimming pools, bathing beaches, skating rinks, or other places providing facilities for physical exercise; or".

Sec. 2. The amendment made by this Act shall apply only with respect to amounts paid on or after the first day of the first month which begins more than ten days after the date of enactment of this Act for admission on or after such first day.

Surplus Record Magazine,
Chicago, Ill., April 22, 1954.

Re H. R. 8300, section 167.

Senator Eugene D. Millikin,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

Dear Senator Millikin: Industry has spoken emphatically against the proposed amendment to the Internal Revenue Code which would permit a double depreciation rate on only new machinery, equipment, plants and buildings acquired after December 31, 1953.

On April 9 we mailed 31,000 questionnaires to as many plants throughout the Nation and the lead question was: "When you invest your money in surplus, used or rebuilt machinery, don't you think that you should be entitled to depreciation comparable with that allowed on any new machines you might purchase?"

Approximately 94 percent of those who replied stated, "Yes." Most of these plant owners and operators felt that to discriminate between any newly acquired capital assets would be unfair.

This sample of opinion came from plant executives who are sufficiently concerned about this legislation to express such opinions as, "might put us out of business," "rough competition for next 5 years—unfair," "actually you should be able to depreciate the used equipment faster than new," "when I buy a machine it is new to me."

At this writing the replies to our questionnaire came from firms with millions in capital investment and employing an estimated quarter of a million people. They are composed of manufacturers with up to 95,000 employees and small machine shops operating with 5 or 6 men. A cross section of industry in all categories is well represented by manufacturers of farm machinery, machine tools, electronics, foundries, automotive and aircraft components, forge shops,

textile mills, steel plants, chemical plants, tool and die shops, small machine shops, road contractors, engineering and contracting firms, shipbuilders, and hundreds of others too numerous to classify.

Our survey indicated that the small percentage who were in favor of the proposed accelerated depreciation rate on new machinery only represented those who would benefit by the sale of new machinery and equipment, or others engaged in manufacturing businesses which are geared especially to high-speed automatic machinery, which depreciates faster through wear and tear, rather than through the factor of age obsolescence.

We can see no objection to this amendment if it applies to equipment or properties newly acquired whether new or used. In fact, even some of the original proponents of this program seem to agree that this change would be acceptable.

Sincerely,

THOMAS P. SCANLAN,
Editor and Publisher.

P. S.—The contents of this letter will be published as my editorial in the May issue of Surplus Record Magazine which is now on the press.

PRUDENTIAL ACCEPTANCE CORP.,
Los Angeles, Calif., April 21, 1954.

Re section 275 and section 312 (c) and (d) of H. R. 8300.

Hon. EUGENE D. MILLIKIN,
United States Senator and Chairman, Senate Finance Committee, Washington, D. C.

DEAR SENATOR: We have been informed that the Senate Finance Committee will soon conduct hearings on this bill.

We desire to enter our objections and protest to the passage and approval of these provisions of this bill. Such provisions would impose an inequitable tax burden and would create a definite obstacle to normal and sound commercial progress. Undue and unnecessary hardships would result especially at the occurrence of financial emergencies.

Very truly yours,

PRUDENTIAL ACCEPTANCE CORP.,
By HARRY C. SCHLEH, *Vice President and Secretary.*

1440 BROADWAY, NEW YORK, N. Y., *April 20, 1954.*

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee, United States Senate, Washington, D. C.

DEAR SIR: In the general rewriting of the Internal Revenue Code, as introduced by the House of Representatives in H. R. 8300, the section dealing with nonbusiness bad debts of taxpayers other than corporations (sec. 23 (k) (4)), was amended by section 166 (d) (2) merely to the extent of providing that a bad debt arising from a trade or business may be deducted as a business bad debt even though the taxpayer is not so engaged when the debt becomes worthless. This proposed amendment merely changes the interpretation of the Treasury Department concerning the retired grocer in section 39.23 (k)–6 (c), Reg. 118.

Such proposed amendment corrects only a slight phase of the narrow construction given by the Treasury to the nonbusiness bad-debt provision.

The annexed discussion of an additional amendment to such provision is respectfully offered for your consideration and submission.

Further, it is submitted, that the effective date of such amendments should be made retroactive to all years open and presently under consideration by the Treasury.

Yours respectfully,

MURRAY KURMAN.

ADDITIONAL AMENDMENT (WORDS IN ITALICS)

SEC. 166. BAD DEBTS

* * * * * * *

(d) NONBUSINESS DEBTS.—

(1) GENERAL RULE.—In the case of a taxpayer other than a corporation—

* * *

(2) NONBUSINESS DEBT DEFINED.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business; *or*

(C) a debt created or acquired (as the case may be) in connection with a trade or business in which the taxpayer has a financial interest, either as shareholder, partner or coventurer.

LAW AND DISCUSSION

The proposed addition of subdivision (C) to sec. 166 (d) (2), as above, would accomplish the following:

1. It would apply more equally the treatment to be given an individual taxpayer as is presently given to a corporate taxpayer.

2. For a period of 25 years, commencing with the case of *T. I. Crane* (17 B. T. A. 720 (1929)), and continuing with *Vincent C. Campbell*, 11 T. C. 510 (1948)), *Henry E. Sage* (15 T. C. 299 (1950)), *Jacob Mark* (10 T. C. M. 702 (C. C. H., 1951)), *J. Stoddell Stokes, Est.* (10 T. C. M. 1111 (C. C. H., 1951), aff'd 200 Fed. (2d) 637 (C. C. H. 3, 1953)), and other cases, the Tax Court and its predecessor, the Board of Tax Appeals, had consistently followed the principle that if an individual "invests in a number of businesses and takes a part in their management over and above passively giving financial aid, * * * he is in the business of investing and personally participating in various ventures," and any loss resulting from a loan to one of such ventures was deemed to be a business bad debt.

This view was followed by the Tax Court in the case of *Weldon D. Smith* (17 T. C. 135 (1951)). But the Court of Appeals for the Second Circuit reversed this ruling in 203 Fed. (2d) 310 (1953), on the ground that the taxpayer was not "regularly engaged in *lending money* to business enterprises." (Italics ours.) Certiorari was denied the taxpayer in 346 U. S. 816 (1953).

This reversal has disturbed the planning of many taxpayers, as well as the thinking of many tax practitioners and tax writers, in view of the fact that the Treasury Department is now unalterably persistent in its findings that active promoters, financiers, and investors in business enterprises will be allowed only nonbusiness bad debts while those engaged strictly as "money lenders" will be allowed business bad debts, upon their losses on loans made in their respective ventures.

The proposed addition of subdivision (C) would correct this inequity; and, further, would permit a business bad debt deduction even to a taxpayer who has an interest as a shareholder, partner, or coventurer in only one business.

HEALTH AND ACCIDENT UNDERWRITERS CONFERENCE,
Chicago 4, Ill., April 22, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senator, Colorado,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: Enclosed is a copy of a memorandum setting forth this organization's position with respect to certain phases of H. R. 8300, presently being considered by the Senate Finance Committee.

We have taken the liberty of sending a copy of this letter and the memorandum to each member of your committee, and 20 copies to Mr. Serge N. Benson of the committee staff. We respectfully urge your consideration of our position.

Sincerely,

JOHN P. HANNA, *Managing Director.*

MEMORANDUM

Re H. R. 8300

To: Members of the Senate Finance Committee, 83d Congress.

Submitted by: The Health and Accident Underwriters Conference.

The Health and Accident Underwriters Conference is composed of more than 200 insurance companies selling both group and individual disability insurance. Approximately one-half of the companies are organized on a capital-stock basis. On behalf of these companies and the several thousand individuals owning their

stock, we wish to register protest relative to certain provisions contained in H. R. 8300. On behalf of all conference companies—mutual, reciprocal, and fraternal, as well as stock—and thousands of their insureds, we wish to indicate opposition on another phase of the proposed measure.

STOCKHOLDERS AND STOCK INSURANCE COMPANIES

As presently proposed section 34 provides a credit for individuals, section 116 allows for a certain percent of dividend earnings to be excluded from an individual's gross income, and section 243 permits a corporation to deduct a percentage of dividend earnings from taxable income. All of these provisions are specifically excluded with respect to insurance stock companies and insurance stock (secs. 34 (c) (1), 116 (b), 246 (a) (1)).

We see no logic in insurance stock being subjected to this discriminatory exclusion and no explanation has been made available to this industry and its stockholders. The stock casualty insurance companies pay taxes on a basis consistent with general mercantile and manufacturing businesses. Stock life-insurance companies, being purveyors of long-term contracts which necessitates a different method of determining income, pay taxes under another section of the code. Both are taxed as corporations. Both should logically be treated no differently than other corporations in this instance.

Millions of Americans are protected in an increasingly better manner against the hazards of economic loss due to illness. The service provided by stock insurers active in this field is of inestimable value to the welfare of the United States. They help provide dramatic evidence of the superiority of a private approach in fulfilling needs and demands of our citizens with respect to this hazard as opposed to a governmental approach. To create a situation which would make the investment of risk capital in this worth-while field less attractive than investment in other fields can well lead to crippling a vital and important service.

DEDUCTIONS FOR THOSE RECEIVING BENEFITS FROM INSURANCE

Under the current revenue law, section 22 (b) (5), individual employees are not taxed for amounts received as compensation for injuries and illnesses. Section 105 of H R. 8300 would limit such amounts to $100 a week or less, provided the plan under which such benefits are received is a qualified plan as described in the bill, and provided the plan is one wherein the employer contributes premium dollars.

One of the great domestic problems and one of the important insurance revolutions in recent years is concerned with persons getting adequate economic insulation from medical and hospital costs. It is well known that insurance organizations have made rapid strides in meeting this issued by providing protection in many ways. The employer-employee group plans are one of the more striking examples. We believe that the Government should encourage stability and thrift on the part of its citizens. We quite earnestly feel that section 105 tends to defeat this worth-while objective. The protection purchased not within the stated dollar limits and not qualified under the bill would be just as valuable to recipients of the benefit dollars. That protection would be used for exactly the same purpose as the protection which qualifies.

Certainly it is recognized that insurance companies are vitally interested in the amount and use of such benefit dollars. Insurance companies could not long operate if insured citizens profited from these benefits. Most people spend benefit dollars directly to pay medical and hospital costs. Some money may be spent on indirect costs such as drug bills, purchase of equipment needed, assistance toward paying for services which would normally be performed by the incapacitated insured, etc. From an insurance company point of view, there must be a control of these benefits.

It is our belief that the legislation proposed with respect to this issue will tend to minimize and channelize the sort of protection which is made available.

Under present law, the protection furnished by insurance companies is taxed in two ways. The States collect an average of slightly more than 2 percent on the premiums in the form of a tax. The Federal Government collects a tax under the Internal Revenue Code. Most uninsured plans, provided by a few large corporations, are not so taxed, but the individuals receiving benefits are taxed. This situation makes for substantial equity. Naturally, the proposal would create an inequity. While it can be argued that other large corporations are

well able to provide the protection themselves, the fact remains that many have no desire to do so. More important, what of the small companies wishing to provide group insurance protection which cannot finance independent plans? The small-business man must compete in a labor market with large companies in many areas. Wholly apart from welfare motives, he will be discriminated against in getting the employee protection he and his employees want.

It is of more than passing interest that at both State and Federal level, loss of tax revenue from carirers will follow the loss of group plans presently sold to large employers. The loss of such plans will unquestionably follow if this section of the bill is enacted into law.

We believe that section 105 should be eliminated in its entirety.

CONCLUSION

For reasons assigned, we suggest a most careful review of the sections of the code mentioned in this memorandum. We believe that justice, equity, and logic will indicate the desirability of making these changes. We urge your most careful consideration of our comments.

Respectfully submitted.

HEALTH AND ACCIDENT UNDERWRITERS CONFERENCE,
JOHN P. HANNA, *Managing Director.*

H. E. KELLEY & CO., INC.,
New Church, Va., April 22, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington 25, D. C.

DEAR SENATOR MILLIKIN: This follows telephone conversation today with a member of the committee's staff, Mrs. Voigt.

Owing to the crowded schedule for oral testimony, it was suggested that there be submitted on paper whatever matter was desired to be brought to the attention of your committee, and that this be delivered in time to meet the deadline on Friday, April 23.

There is attached hereto a copy of H. R. 158, 83d Congress, 1st session, a bill to define partnerships and partners for income-tax purposes. This bill proposes, in reference to paragraph (a) (2) of section 3797 of the Internal Revenue Code this:

"An individual shall be considered a bona fide partner if he has contributed either services, other than services solely of a clerical or manual nature, or capital (including an interest in the partnership business) to the partnership. An individual shall be deemed to have contributed capital even though the capital (including an interest in the partnership business) contributed was the result of a gift from such individual's spouse, father, mother, son, or daughter and shall be considered a partner with respect to his distributive share of the ordinary net income or the ordinary net loss of the partnership in accordance with the partnership agreement."

Also attached is a copy of a write-up concerning an actual case of what has happened under existing law, the purpose of which is to illuminate practical reasons why this amendment is desirable.

Speaking from the experience had during 8 years of controversy, controversy created by existing law, it would be appreciated if the committee will give consideration to the insertion proposed by H. R. 158.

Sincerely yours,

H. E. KELLEY.

MEMORANDUM

Re partners and partnerships—H. R. 8300, a bill to revise the internal revenue laws of the United States

1. House Report 1337, 83d Congress, 2d session, page 65, chapter XXII, Partners and Partnerships; and I quote:

"The existing tax treatment of partners and partnerships is among the most confusing in the entire income-tax field. The present tax provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result, partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences."

And, again in paragraph 3 of this chapter: "Because of the vital need for clarification, your committee has undertaken the first comprehensive statutory treatment of partners and partnerships in the history of income-tax laws. In establishing a broad pattern applicable to partnerships generally, the principal objectives have been *simplification, flexibility, and equity*." (Italics furnished.)

2. Section 3797 of the code statutory provisions; definitions. Section 3797 (a) (2), Partnership and Partner:

"The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization.

"A PERSON SHALL BE RECOGNIZED AS A PARTNER FOR INCOME TAX PURPOSES IF HE OWNS A CAPITAL INTEREST IN A PARTNERSHIP IN WHICH CAPITAL IS A MATERIAL INCOME-PRODUCING FACTOR, WHETHER OR NOT SUCH INTEREST WAS DERIVED BY PURCHASE OR GIFT FROM ANY OTHER PERSON." (Capitals furnished.)

3. The Revenue Act of 1951 was followed by Internal Revenue Service mimeograph 6767 (copy hereto attached).

4. When a taxpayer has read and has tried to understand mimeograph 6767, the reason for the language of H. R. 158 becomes apparent.

CONCLUSION

As one who has struggled with tax law and regulations pertaining to partnerships and partners, I request the committee's consideration, please, for the insertion in the definition of partners and partnerships, section 3797 of the code, of the language proposed in H. R. 158.

April 23, 1954.

[H. R. 158, 83d Cong., 1st sess.]

A BILL To define partnerships and partners for income-tax purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

DEFINITION OF PARTNERSHIP AND PARTNER

SECTION 1. Paragraph (a) (2) of section 3797 of the Internal Revenue Code is amended by inserting at the end thereof the following:

"An individual shall be considered a bona fide partner if he has contributed either services, other than services solely of a clerical or manual nature, or capital (including an interest in the partnership business) to the partnership. An individual shall be deemed to have contributed capital even though the capital (including an interest in the partnership business) contributed was the result of a gift from such individual's spouse, father, mother, son, or daughter and shall be considered a partner with respect to his distributive share of the ordinary net income or the ordinary net loss of the partnership in accordance with the partnership agreement."

TAXABLE YEARS TO WHICH APPLICABLE

SEC. 2. The amendment made by section 1 shall be applicable with respect to taxable years beginning after December 31, 1940.

Com.-Mimeograph, Coll. No. 6767, R. A. No. 1893, A. S. No. 705

FEBRUARY 19, 1952.

TREASURY DEPARTMENT, OFFICE OF COMMISSIONER OF INTERNAL REVENUE, WASHINGTON 25, D. C., BUREAU POSITION FOR TAXABLE YEARS BEGINNING PRIOR TO JANUARY 1, 1951, WITH RESPECT TO FAMILY PARTNERSHIPS IN WHICH CAPITAL IS A MATERIAL INCOME-PRODUCING FACTOR

COLLECTORS OF INTERNAL REVENUE, INTERNAL REVENUE AGENTS IN CHARGE, HEADS OF FIELD DISTRICTS OF THE APPELLATE STAFF, AND OTHERS CONCERNED

In *Commissioner* v. *Culbertson* (337 U. S. 733, 1949-2 C. B. 5), the Supreme Court further clarified the principles governing the recognition of family members

as partners for income-tax purposes, as developed earlier in *Commissioner* v. *Tower* (327 U. S. 280, 1946-1 C. B. 11), and *Lusthaus* v. *Commissioner* (327 U. S. 293, 1946-1 C. B. 9).

Certain of the principles developed in the Culbertson opinion are well understood: (1) That a partnership is an organization for the production of income to which each partner contributes one or both of the ingredients of income, capital, or services; (2) that sections 181 and 182 of the Internal Revenue Code, which govern the taxation of the income of "individuals carrying on business in partnership," must be read in the light of their relationship to sections 11 and 22 (a), relative to the taxation of individual incomes; (3) that to recognize as partners within the meaning of sections 181 and 182 persons who contributed neither capital nor services to the business during the taxable years in question would violate the first principle of income taxation, that income must be taxed to him who earns it; (4) that an intent to provide money, goods, labor, or skill "sometime in the future" is hence not enough to justify recognition of the person having such intent as a partner, as against the demands of sections 11 and 22 (a) of the code that he who presently earns the income of a business through his own labor and skill and the utilization of his own capital be taxed therefor; and (5) that the sufficiency of the contribution of an alleged partner is a question of fact to be determined, upon consideration of all the facts, through applying the basic test of the reality of a family partnership for income-tax purposes, whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." It is a corollary of those principles, recognized in the Culbertson decision itself, that a partnership may be valid for income-tax purposes as to some alleged partners but not as to others.

This mimeograph is designed to clarify the position of the Bureau with respect to some aspects of the family partnership problems for taxable years beginning prior to January 1, 1951, concerning which there appears to be uncertainty. In one way or another the aspects of the problem that will be discussed have to do with the question whether an alleged partner is the real owner of an interest in the capital of a partnership which is attributed to him. This mimeograph is applicable only to cases in which capital is a material income-producing factor.

It is emphasized that this mimeograph does not attempt either to provide a ready formula for the solution of family partnership cases or to state comprehensively all of the principles that are applicable in such cases. The matters here dealt with are accordingly to be understood in their relationship to the total fact picture in the particular case and to the basic principles of the Culbertson opinion set our above, which will not be further elaborated.

1. Reality of capital contribution.—That a family member has acquired his partnership interest by or as the result of a gift, purchase, or loan from the taxpayer, and has not contributed to the partnership capital originating with himself, remains one of the factors to be considered. It should be understood, however, that the absence of original capital creates rather than answers the problem whether a questioned partner is entitled to recognition. It presents in all cases an issue for the exercise of sound judgment on all of the facts of the particular case as to whether a partnership in good faith was intended by the parties.

(*a*) *Basic tests as to gift capital.*—With respect to gift capital the answer turns upon the application of the overall test of good faith laid down in the second portion of the Culbertson opinion to all of the facts bearing upon the concept of real ownership evolved in the third portion of that opinion, reading in part as follows:

"We did not say [in the Tower opinion] that the donee of an intrafamily gift could never become a partner through investment of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in *Helvering* v. *Clifford*, supra. The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes."

* * * * * * *

"But application of the Clifford-Horst principle does not follow automatically upon a gift to a member of one's family, followed by its investment in the family partnership. If it did, it would be necessary to define 'family' and to set precise limits of membership therein. We have not done so for the obvious reason that existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem. It is frequently stated that transactions beween members of a

family will be carefully scrutinized. But more particularly, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. He is able, in other words, to retain 'the substance of full enjoyment of all the rights which previously he had in the property.' *Helvering* v. *Clifford*, supra at 336.

"The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. The Tower case recognized that one's participation in control and management of the business is a circumstance indicating an intent to be a bona fide partner despite the fact that the capital contributed originated elsewhere in the family. If the donee of property who then invests it in the family partnership exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income—he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. In the Tower and Lusthaus cases we distinguished between active participation in the affairs of the business by a donee of a share in the partnership on the one hand, and his passive acquiescence to the will of the donor on the other. This distinction is of obvious importance to a determination of the true intent of the parties."

In the ordinary gift capital case the question whether a donee's partnership interest represents a mere "surface change of ownership," or conversely whether the donee has exercised dominion and control over his or her interest, represents the heart of the issue whether a partnership in good faith was intended, at least in those cases where the donee has not performed substantial services. In turn, all of the elements of the test of good-faith intent laid down in the Culbertson opinion has immediate bearing upon the reality of the donee's ownership, those elements being—

"* * * whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

The ascertainment of the presence or absence of dominion and control in a donee over his or her partnership interest through the application of this test of good-faith intent means, of course, that all of the facts indicative of the exercise or nonexercise of control by the donee must be taken into account, and that single facts such as the donor's retention of a majority interest entitling him to outvote the donee can never be regarded as determinative in themselves. Some of the more important evidentiary matters indicative of the presence or absence of such dominion and control in donees in gift capital cases are discussed in subsections (b), (c), (d), (e), and (f) of this section.

(*b*) *Documentation not controlling.*—The execution of legally sufficient and irrevocable deeds or other instruments of gift may under State law be essential to the validity of an alleged gift but is of course of less ultimate significance than the conduct of the parties after the gift has been made. Reality and good faith are not ascertainable by any mechanical or formalistic test.

(*c*) *Participation in management.*—Participation in the control and management of the business (as distinguished from the regular performance of nonmanagerial services) is not essential but is strong evidence of a donee partner's exercise of dominion and control if such participation is substantial. Substantial participation in management does not necessarily involve continuous or even frequent presence at the place of business, but it does involve genuine consultation with respect at least to major business decisions, and it presupposes substantial acquaintance with and interest in the operations, problems, and policies of the business, along with sufficient maturity and background of education or experience to indicate an ability to grasp business problems that is appreciably commensurate with the demands of the enterprise concerned. Vague or general statements as to family discussions at home (or elsewhere) will not be accepted as a sufficient showing of actual consultation, but evidence of genuine consultation with respect to specific matters is entitled to consideration even though it has taken place in the home. Evidence of genuine consultation with respect to the distribution of profits or their retention in the business is significant, but it is not indispensable. This subsection presupposes a donee's freedom

to participate in management; exclusion from the right so to participate is dealt with in subsection (d) of this section.

(d) *Retained controls—Donee's rights to withdraw.*—On the other hand, the donor may have retained such complete controls of assets essential to the business (for example, through retention of title to assets leased at will or for a relatively short term to the alleged partnership), or of income distributions, business management, and the sale or withdrawal of the interest of the donee, that the gift and the partnership interest stemming from it should be considered more nominal than real and the donor should be treated as remaining the substantial owner of the interest, so that a partnership in good faith could not be predicated upon the donee's capital interest alone. The result should be the same if the donor can control the earning of income by the alleged partnership through his control of a nominally separate business organization of which the alleged partnership is really an adjunct or upon which it otherwise depends directly or indirectly for its income.

The presence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts as tending to show the absence of intent in good faith to join the donee as a partner. While it is intended in this subsection to refer to controls exercisable under some provision of the gift instrument or partnership agreement, a general passive acquiescence of the donee in the will of the donor, as evidenced by the actual conduct of the parties, may be the equivalent of expressly retained controls.

It is not uncommon in ordinary business relationships for one partner to be made managing partner or to have voting control, and retention by the donor of control of business management or of voting control, standing alone, is of little significance unless the donee either legally or in a practical sense would not be free to withdraw his or her interest whenever dissatisfied with the way in which the business is being conducted. In deciding whether a donee has such freedom to withdraw it is pertinent to consider all facts indicative generally of the donee's independence of, or dependence upon, the donor; whether the donee has such maturity and understanding of his or her rights as to be capable of deciding to exercise, and of exercising or bringing about the exercise of, such rights; and whether he or she can do so without suffering financial loss (because the partnership agreement would permit one or more of the partners to purchase the donee's interest for substantially less than its fair market value). Freedom to withdraw, in the sense here indicated, is also evidence of the reality of a donee's interest in cases where the donor has not retained any controls.

(e) *Income distributions.*—If the donor has not retained significant controls of the type dealt with in subsection (d) above, the actual distribution to a donee partner of all or the major portion of his distributive share of the business income (over and above amounts used for income tax payments) is entitled to substantial weight as evidence of the reality of the donee's interest, provided that the amounts distributed were used or were available for the donee's enjoyment, freed from the donor's control. As the Court stated in the Culbertson opinion, "Whether [a donee] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise." Even if significant controls have been retained by the donor, such distributions to a donee partner are entitled to some weight, unless the controls retained by the donor amount to substantial ownership.

On the other hand, distributions wholly or principally used to pay the donee's income tax, or applied for the donor's benefit (as for the payment of family expenses for which the donor is legally responsible), or deposited, loaned, or invested in such ways that the donor controls or can control their use or enjoyment, fall short of establishing real enjoyment by the donee. Nevertheless, the retention of partnership earnings with the acquiescence of the donee for the reasonable needs of the business is not inconsistent with bona fide ownership by the donee.

(f) *Evidentiary matters in general.*—The discussion in subsections (c), (d), and (e) of this section of participation in management, retained controls, and income disributions is designed to emphasize the importance of those factors as evidence of the reality (or lack of reality) of intrafamily gifts. To give them weight accordingly does not affect the relevance of other evidentiary facts ordinarily taken into account, such as compliance with local partnership or fictitious name registration statutes; other publicity given to the partnership arrangements, particularly as affecting trade channels and banks or other sources of financing; control of business bank accounts; recognition of the

interests of questioned partners in appropriate capital and drawing accounts in the books of account, in insurance policies, leases, and other business contracts, and in litigation affecting the business; and the ultimate realization or exchange of the interests of questioned partners if the business has been liquidated or incorporated, though the remoteness in point of time of such liquidation or incorporation may lessen the weight that should be given the facts in that regard. For the exercise of sound judgment all relevant facts, both favorable and unfavorable to the taxpayer, must be taken into account.

(*g*) *Purchased interests—Loans.*—The foregoing principles with respect to the reality of intra-family gifts are not applicable, except to the extent provided in this subsection, for determination of the reality of the ownership of partnership interests acquired from a family member through alleged purchase, or resulting from a loan by such family member or with the aid of his or her credit. In such cases the reality of the ownership resulting from the transaction is considered to turn primarily upon whether the alleged purchase or loan was bona fide as such, in the sense that a real obligation was intended, enforceable against the purchaser or borrower irrespective of the success or failure of the partnership venture. If the alleged purchaser or borrower had insufficient means or credit standing to meet the obligation except out of partnership earnings, the transaction may amount to a gift subject to deferred enjoyment (that is, with the income reserved by the seller or lender until the alleged obligation has been fully paid). But the transaction does not necessarily fall in one or another of these categories; it may be lacking in reality either as a gift or as a bona fide purchase or loan.

The Bureau will accept the bona fides of an alleged purchase or loan transaction if it meets either of the following basic tests:

(I) That it has the usual characteristics of an arm's length transaction, considering the terms of the agreement itself (as to price, due date of payment, rate of interest, and security, if any); the credit standing of the purchaser or borrower apart from family relationship to the seller, lender, or endorser; and the capacity of the purchaser or borrower to incur a legally binding obligation; or

(II) Assuming the lack of one or more usual characteristics of arm's length dealing, that the transaction was genuinely intended to promote the success of the business through securing participation in the business by the purchaser or borrower, or the addition of his or her credit to that of other participants.

Until the alleged purchase price or loan has been fully paid or the obligation has otherwise been discharged, the indicia of reality with respect to the ownership of gift capital under the foregoing subsections of this section will be taken into account in such cases only as an aid in determining doubtful questions as to whether a bona fide purchase or loan obligation was intended by the parties. They are relevant to that limited extent, except that purported income distributions to the purchaser or borrower used for payment of the purchase price or loan are entitled to little weight.

2. Sufficiency of capital contribution—Services. The principles stated in this mimeograph are of course concerned only with cases in which capital is a material income-producing factor. They are also inapplicable in cases where the capital contribution of a questioned partner must be accepted as having been really his at some time before its contribution to the partnership, but similar principles may be useful in determining the reality of such prior ownership where the capital was acquired from a family member.

If the interest of any questioned partner represents capital which is really his under the principles stated in section 1, and if such capital is not clearly unnecessary to the conduct of the business, such questioned partner is ordinarily entitled to recognition. That is so whether or not he or she performs any services for the partnership. The performance of substantial services may entitle a questioned partner to recognition, but there is no rule that makes the performance of services indispensable to recognition as a partner in gift capital cases or otherwise. See, however, section 7 below as to the reasonableness of the agreed division of profits as bearing upon bona fide partnership intent, and as to allocation.

3. Motive and business purpose.—One of the most troublesome things that has crept into the family partnership field is the notion that the admission of a family member or trust to a business as a partner must have been intended in some way to promote the success of the business. The thought is most often stated negatively, as in comments to the effect that a questioned partner has not contributed any "new capital", that he has contributed neither capital nor serv-

ices that were not already available to the business, and that no business purpose has been served by the admission of the questioned partner for either of those reasons; hence, that there is an absence of required business purpose and nonrecognition must follow. Expressions of similar import can be found in the opinions in some of the decided cases, and they have at times been thought to lay down a rule of law as to the need for business purpose in antecedent family transactions as well as in the partnership undertakings predicated upon them.

The Bureau considers that the absence of "new capital" or added services, like the absence of "original" capital, is but a part of the total picture to be considered in appraising the reality, good faith, and business purpose of family partnership arrangements. Reference has generally been made to such matters in the decided cases only where there was an absence of other facts deemed to support the reality and good faith of the acts of the parties.

In any event, the Bureau does not adhere to the position that there is an absence of required business purpose if a gift or other antecedent family transaction does not benefit the business in some way. An individual is entitled freely to dispose of his or her property so far as the income-tax law is concerned and may give or sell interests in a business to members of his family. The question with which the law concerns itself is whether the individual has really done so. There is no requirement that intra-family gifts be motivated by a business purpose, which frequently they would not have, before the donee may be recognized as the owner for income-tax purposes of the property given to him, and the same is true of other antecedent family transactions.

The Culbertson opinion stated a test of intent, whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." The Bureau considers that the test of business purpose may be satisfied by the single fact (if it be a fact) that the questioned partner has invested in the business money or property, useful to the business, of which he or she is the real owner under the principles stated in section 1 hereof, even though such money or property had already been used in the business before the questioned partner acquired any interest therein. That conclusion is abundantly demonstrated by the action which the court took in the Culbertson case itself in remanding it for factual decision whether there was "a bona fide intent that [the sons] be partners in the conduct of the cattle business, either because of services to be performed during [the taxable] years, or because of contributions of capital of which they were the true owners, as we have defined that term in the Clifford, Horst, and Tower cases."

That is not to say that the presence or absence of a tax-avoidance motive behind intrafamily transactions and partnership arrangements is to be ignored. The presence or absence of a tax-avoidance motive is one of many factors to be weighed in the determination of the reality of an intrafamily gift, sale, or loan and of the existence of bona fide partnership intent. The presence of a tax-avoidance motive, however, is of no consequence if the reality of the transfer of interest and the good faith of the parties are satisfactorily established.

4. Trustees as partners.—For income-tax purposes supplement E of subchapter C of chapter 1 of the code treats trusts as if they were recognizable legal entities. In the family partnership field, however, the question properly to be considered is ordinarily whether the trustee is entitled to recognition as a partner in relation to the trust. The Bureau does not adhere to the view that a trustee cannot in any circumstances become a partner for tax purposes, regardless of some judicial expressions of such a rule.

Recognition of a trustee as partner for tax purposes must turn upon the principles relative to family partnerships generally, and especially those stated in section 1 hereof, as applied to the particular facts of the trust-partnership situation. If the trustee is the grantor or if he is a person subservient or amenable to the will of the grantor, the provisions of the trust instrument particularly with relation to whether the trustee is freed from or subject to the normal responsibilities and liabilities of a fiduciary, the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of gift capital useful to the business and whether a partnership in good faith was intended.

In the absence of a substantial question whether the trust income is in any event taxable to the grantor, a trustee unrelated to and independent of the grantor, and subject to the ordinary responsibilities of a fiduciary, who as general partner has participated in management or has received actual distribution of all or a major part of the share of income distributable to the trust will

ordinarily be accepted as the real owner of the partnership interest which he holds for the trust and as a bona fide partner, unless the grantor has retained such controls as to remain the substantial owner of that interest in accordance with section 1 (d). As to trustees as limilted partners, see also section 6 below.

That the trustee is also a partner in his individual capacity does not preclude his recognition in relation to the trust under the foregoing principles but does warrant special scrutiny to ascertain whether as trustee he is subservient or amenable to the wishes of the grantor or is really representing the interests of the trust in a fiduciary capacity.

5. Interests of minor children (not held in trust).—The recognition of minor children as the real owners of interests in partnership capital acquired by them in antecedent family transactions depends upon the application of the same principles as are applied generally in determining whether any family member is entitled to recognition as a partner for income-tax purposes, and the principles of this statement will be so applied. See especially section 1 above. It is necessary in so doing, however, to take account of special problems not only as to the legal disabilities of minors (including the control which the law ordinarily vests in others over their property), but also as to the actualities of the relative maturity or immaturity of minor children in particular cases.

The Bureau recognizes that in some instances a minor child may have sufficient maturity and experience to be treated by disinterested persons as competent to enter into business dealings and otherwise to conduct his or her affairs on an equal plane with adult persons. The Bureau will not press the legal disabilities of a minor under State law so far as to deny the competence of such individuals to control their property where the evidence clearly shows the existence of such competence in fact. The disabilities of minors under State law will, however, be taken into account in determining whether a minor has control of property in other cases, it being presumed that such disabilities are necessary for the protection of the interests of the minor by reason of his or her immaturity, lack of experience, or submission to parental authority. Except upon a clear showing of the actual competence of a minor child, the Bureau will presume that control over his or her property is exercised by some other person.

Where it is claimed that the property of a minor child is controlled by another person, who purports to represent the child in relation to a partnership of which the child is an alleged member, the recognition of the child as the real owner of an interest in partnership capital will depend (subject to other principles of this statement) upon whether such control is in a real sense exercised in a fiduciary capacity for the sole benefit of the child and whether there is such judicial supervision of the conduct of the fiduciary as reasonably to assure that the property of the child cannot be used for the benefit of another. The use of the child's property or income for support for which a parent is legally responsible will for that purpose be considered a use for the parent's benefit.

Judicial supervision of the conduct of a fiduciary will be deemed adequate to assure that the property of a minor cannot be used for the benefit of another if such supervision extends to all investments made by the fiduciary and is continuously exercised. It is considered that rules of State law which, despite the absence of such judicial supervision, hold a person controlling or dealing in a minor child's property responsible and accountable as a fiduciary are ordinarily not in themselves sufficient to assure the use of the property and its income solely for the benefit of the child; such liability, being dependent upon the institution of a suit or other proceeding for its enforcement, is subject to the interplay of family influence and other extraneous considerations to such an extent that it is not deemed an effective restaint upon parents or other persons who may be subject to it.

6. Limited partnerships.—The limited partnership device, assuming that it does not appear in such form that the organization should be treated as an association taxable as a corporation, presents a special type of family partnership problem. It is one of the fundamental characteristics of a limited partnership under the Uniform Limited Partnership Act, now law in many States, that a limited partner may not engage in the management of the business without subjecting himself to liability as a general partner. Hence, significance cannot be attributed to the absence of services and participation in management on the part of a limited partner in determining whether a partnership in good faith was intended. On the other hand the limited-partnership device lends itself readily to the retention of important controls in the taxpayer if he be a general partner, and the interests of limited partners can be made more nominal than real.

The vesting of management powers in the general partner or partners is one element. The interests of limited partners may also be made unassignable in any real sense and may be required to be left in the business for a long term of years, subject only to the right of the limited partner to bring about dissolution and an accounting for his interest by court decree, upon proof of some wrongdoing or unfitness of the general partner or partners or of special circumstances rendering a dissolution equitable. Particularly where the general partner or partners have discretion as to distributions of income to limited partners it may be that all substantial incidents of ownership are retained by the donor as general partner.

There can be no hard-and-fast rule as to the recognition of limited partners. The incidents of any limited partnership depend in part upon the nature of the agreement or limited partnership certificate and the respective rights and interests of general and limited partners as there provided for. The tests of section 1, and especially subsection (*d*) thereof, should be applied in the light of the incidents of the relation under the applicable limited-partnership statute, the provisions of the partnership agreement or certificate, and all the facts of the particular case.

7. *Reasonableness of agreed division of profits—Allocation.*—A wholly unreasonable agreement as to the sharing of partnership income may be evidence of the absence of bona fide partnership intent and along with other pertinent evidence may invalidate the partnership for tax purposes. Even if a partnership is entitled to recognition for tax purposes under the foregoing and other applicable principles, however, the agreed division of profits should be scrutinized to ascertain whether it involves the donative deflection of income attributable to personal services or the division of other income in disproportion to capital interests of which the recognized partners are accepted as the real owners. If the agreed division of profits does not reasonably accord with ordinary business arrangements of parties dealing at arm's length, considering the respective contributions by the recognized partners of services, skill, credit, and capital of which they are the real owners, it may be appropriate, to make a fair allocation to divide the income in shares to which persons dealing with each other at arm's length would reasonably agree under the particular circumstances, taking into account the relative proportions of the income attributable to services and to capital and all such contributions of the several recognized partners. The allocation of adequate, reasonable salaries to active partners before any other division of profits will frequently provide adequate compensation for their contributions of skill and services, and the adequacy and reasonableness of any such salaries allowed by the agreement of the parties should always be considered.

JOHN B. DUNLAP, *Commissioner.*

Limited distribution.

AN ACTUAL CASE OF WHAT THE INTERNAL REVENUE SERVICE HAS DONE UNDER EXISTING LAW AND REGULATIONS

FOREWORD

I received from the staff of the Joint Committee on Internal Revenue Taxation a request for information pertinent to staff work in collecting and analyzing suggestions for improvements in the internal revenue laws and their administration. I was requested to furnish specific case information.

I have furnished such information in the attached pages.

I most respectfully suggest that H. R. 158, 83d Congress, 1st session, a bill introduced by Congressman Noah W. Mason, to define partnerships and partners for income-tax purposes, receive favorable consideration. My experience, a very costly experience, occurring during the absence of such a definition, causes me to urge this action, which will benefit many taxpayers who operate a business on a partnership plan.

H. E. KELLEY.

NEW CHURCH, VA., *January 26, 1954.*

H. E. KELLEY, A PARTNERSHIP

An actual case of what the Internal Revenue Service has done under existing law and regulations.

H. E. Kelley & Co., of New Church, Accomac County, Va., is a partnership of five members, engaged in the canning business.

On May 20, 1946, the Internal Revenue Service informed H. E. Kelley that his income tax was deficient, because the partnership was disallowed for income-tax purposes. Three of the partners, later on (1947), were allowed. The other two were rejected, but, later on (1953), were allowed. The inference was that they were in the partnership for the purpose of avoiding proper income-tax payments. The Government refunded the tax which had been paid by two disallowed partners, and assessed H. E. Kelley personnally on the basis of the changed status. Thus, by putting him into a higher income bracket, it made him liable for a much higher tax payment.

In 1953, the Government conceded that the partnership was bona fide. And that a refund was due Mr. Kelley. However, it seemed the policy to resist payment of claims.

The remedy for such tax situations may be found in the history of the Kelley case as summarized here:

1. Congress should clarify by definition the Administrative Procedures Act. Section 3 (2) of September 1946; Federal Register Act, Sections 5 and 7; Government Organization Manual, revised June 30, 1940; (a) second revision July 1, 1949; (b) third revision July 1, 1953 (c) under "rules" and under "rules making" and under "rules procedure."

2. Delegations of authority to act for the Commissioner. The Administrative Procedures Act, at September 11, 1946, provides: A delegation that is not published in the Federal Register currently when made is without force and effect, and the taxpayer is not bound by it. This law was violated in the Kelley case; the person who made the assessment had no legal power to do so.

3. Section 292 (a) of the Internal Revenue Code provides for interest computations on deficiency tax assessments. The collector is compelled to compute interest to the date at which a deficiency assessment is made. The collector did not comply with this law. His failure to comply with it cost the Government $600 plus. It also provided the Office of the Attorney General with a technical argument that, since the collector did not collect the interest as required by law, this violation placed the taxpayer's deposit under section 322 (b) of the Internal Revenue Code. Under this section of the code, the deposit cannot be refunded because it was made more than 2 years before the date of the claim.

(*a*) Section 272 (d) also provides for the computation of interest on deficiency tax assessments where a waiver (form 870) has been executed by the taxpayer. None was executed. Nevertheless, this is the law the collector applied, under an erroneous assumption that the waiver had been executed.

What is this law? It means that, if the taxpayer wishes to surrender his rights to have his issues tried in a court, he signs form 870. In return, the Government may stop the running of the interest on the proposed tax liability 30 days after it receives the signed waiver agreement.

4. Section 3770 (c), Internal Revenue Code: The case of *Hanley* v. *United States* (105 Ct. Cls. 683). On page 651, the court noted that, in the case of *Rosenman* v. *United States* (323 U. S. 655), it had decided that a deposit was an overpayment, but had been reversed by the Supreme Court. The Court of Claims seized upon Justice Frankfurter's statement, on page 633, that the Supreme Court did not need to consider the effect of the Current Tax Payments Act of 1943 (sec. 3770 (c)), and the Court of Claims stated (dictum) that the amendment to the Current Tax Payments Act, section 4 (d), and section 3770 (c) of the Internal Revenue Code mean that a deposit was, for income-tax purposes, an overpayment. The taxpayer thinks that section 4 (d) of the Current Taxpayers Act of 1943 was in nowise intended to overrule the Rosenman case. The taxpayer is supported in this opinion by Senate Report 221, 78th Congress, 1st session. On page 34, the committee states:

"In the view of your committee, the code does not contemplate that liability for interest can be cast on the Government by merely dumping money as taxes on the collector, by disorderly remittances to him of amounts not computed in pursuance of the actual or reasonably apparent requirements of the code, or not transmitted in accordance with the procedures set up by the code, or by other abuses of tax administration. As to these, your committee believes that a proper application of existing law would enable the courts, in the future as generally in the past, to deny treatment as overpayments to these improper payments."

In the light of the above statements of what the Congress meant, the taxpayer thinks that the Rosenman case is still good authority, and, for that reason, a deposit remitted by the taxpayer in October 1948 was not the payment

of the tax because there was no assessment made until the following year, at January 28, 1949, and the collector did not apply the October deposit to the tax liability until this liability existed. The taxpayer is supported in his view by the Commissioner of Internal Revenue himself, who argued in *Herrick* v. *United States* (108 F. Supp. 20) that a similar deposit was not payment, even when the Commissioner had deducted the amount of a payment from the amount of a deposit in the assessment of a deficiency tax liability. The United States District Court for the Eastern District of New York, in deciding that the payment was made when credited by the Commissioner against the deficiency tax liability, affirmed that the Rosenman case was controlling.

5. Section 3770 (c) of the Internal Revenue Code is the amendment of the Current Taxpayers Act of 1943 discussed in the Hanley case. The Government does not argue with the taxpayer about the intent of the Congress. Nor does it contend that this taxpayer's deposit was disorderly or made in bad faith. On the contrary, it is conceded that this taxpayer's deposit was the result of an honest mistake

6. Section 322 (b) of the Internal Revenue Code refers to the time allowed for the refund of an overassessment of tax. The Government, under this law, contends that it is unable, under any circumstances whatsoever, to refund an overassessment where a deposit was made more than 2 years immediately preceding the filing of the claim for refund. Leaving the citizen taxpayer such remedies as may be found in the Torts Claims Act of the United States under the civil rights rule, in which event the statute of limitation exacted by section 322 (b) (2 years) need not, necessarily, be the end of the road for the taxpayer citizen to recover his overpaid tax.

7. Section 3801. Mitigation of effect of statute of limitation. Here is a law that appear to rest on the word "inconsistent." Be that as it may, this taxpayer is in need of the definition of the Congress of this word for the purposes of section 3801.

8. The 1951 Revenue Act, revision of tax law pertinent to partnerships, together with legislative history which tells of the debates, raises the question which is: What is the intention of the Congress as to the word "open"?

Does open mean that, if a taxpayer has an open year—a tax year—back of 1951, that is open because of adjustments pending or claim filed, as distinguished from the taxpayer who has no open year, may the taxpayer with the open year get a refund? This question stems from a discussion with the head of the Appellate Division on August 3, 1953, who wanted to know if this word "open" meant open for a taxpayer only.

Why, if Congress' debates were aimed at providing relief for taxpayers for their open claims back to 1938, would Congress say that the word "open" as used in the 1951 revision was exclusively for the benefit of the Government, namely, to assess a deficiency tax?

And, if it was the intention of Congress, why is the word "consent" used? Why would a disallowed partner consent to accept the deficiency assessment at a date after the statute of limitations on the assessment had tolled?

9. "That is our policy, Mr. Taxpayer." Government employees assigned to the work of tax claim adjustment face-to-face with the claimant taxpayer have been heard to say, "Because that is our policy, Mr. Taxpayer." An example of how this works: Taxpayer learns that his claim will be allowed, but a refund as provided for by section 322 (b) of the code will not be made. Stripped of its technicalities, this means that the law requires the refund to be made of the full amount of an overassessment, but arbitrary power of men, as opposed to the rule of the Constitution, tells the taxpayer he shall not receive what the law gives him. Why? The Government requires that copies of contingent fee agreements between taxpayers and their representatives be filed with the Government. Observations of these agreements by Government employees causes them to conclude that it will cost the taxpayer not less than 15 percent and up to 33⅓ percent of the amount recovered for legal services necessary if the taxpayer goes to court, and/or must retain an enrolled tax counsel to represent him before the Bureau.

10. "Nobody ever gets it all back, Mr. Taxpayer." Taxpayers hear this statement made by Government employees. Why? Again, these employees are aware that it will cost the taxpayer legal fees and other expenses to take his case to court. Some Americans choose to fight for justice, and the cases pile up in the courts, piling up unnecessary expense to the Government as well as the taxpayer.

11. "No, we will not separate your claims and deal with you on the merits of each of your claims, Mr. Taxpayer." Why? The experience of this taxpayer is that the Government employee arbitrarily, and notwithstanding section 322 (b), refuses to refund an overassessment that is not the subject of a controversy, in order to compel a taxpayer to submit to the opinions and decisions and arbitrary actions of Government employees with respect to overassessments for which there is the slightest controversy. This method is referred to as horse trading. Perhaps the Congress, seeking ways and means for the reduction of the cost of the Government, will decide to determine what the cost of this horse trading is in terms of interest at 6 percent that accumulates while these employees attempt to avoid the refund of 100 cents on the dollar required by section 322 (b).

(NOTE.—Refer to index which will point to addendum with discussions of the several tax laws hereinabove referred to.)

ADDENDUM NO. 1

1. Which of these Government employees, if any, had lawful powers to execute agreements with H. E. Kelley: (1) Fred S. Martin; (2) C. A. G. Dawe; (3) Hoke Murray; (4) G. C. Hammond; (5) Ernest F. Hodgdon; (6) S. L. Crenshaw?

2. At September 11, 1946, the law known as the Administrative Procedures Act provided, among other things, that delegations of authority to employees of the Government in those agencies subject to section 3 of the Administrative Procedures Act (60 Stat. 238; 5 U. S. C. 1002) compelled publication in the Federal Register of such delegations.

3. H. E. Kelley executed a contract at March 15, 1948, with George S. Schoeneman, Internal Revenue Commissioner, by "H. M." If "H. M." (presumably, this means Hoke Murray, internal revenue agent in charge at Richmond, Va.) was (1) the possessor at March 15, 1948, of a lawful delegation of authority from Schoeneman, and (2) was published in the Federal Register showing that such delegation had been furnished by Schoeneman to Murray, a contract with Kelley was made. Otherwise, no contract ever existed. Ergo, the statute of limitations expired; the extension of time contract was without effect, and there is no law under the assessment of Kelley; we have an illegal collection of Kelley's money; a refund must be made.

4. Tie the angles together. (1) Administrative Procedures Act (Stat. 238; 5 U. S. C. 1002), section 3 of this law states that agencies subject to section 3 shall currently publish in the Federal Register delegations of final authority. The Federal Register Act, section 5, refers to the Administrative Procedures Act. Section 7 of the Federal Register Act applies to the Kelley case. Section 7 required the Commissioner, if he did delegate to Fred S. Martin power to assess Kelley, to publish that delegation currently in the Federal Register. A search of the Federal Register for the subject years (1948–49) does not reveal such a delegation of authority. Ergo, the assessment by Martin of Kelley was illegal. A refund must be made to Kelley.

5. Federal Register of September 11, 1946, pages 177–8–23 refers to the Administrative Procedure Act of September 11, 1946, at section 600–2, "Office of Commissioner."

6. Section 3916 (b), Internal Revenue Code, title 26 of the United States Code provides, generally speaking, that the Secretary of the Treasury can delegate authority. It stops there, but the issue is not whether or not he can delegate authority, because he can. However, the issue is: Did he? If he did, our search of the Federal Register does not reveal that he did.

7. Citations of two cases pertinent to our Kelley case, more specifically pertinent to the issue of whom of the numbers of Government employees in the Kelley case had a lawful delegation of authority to act. Baldly stated, unless they were published in the Federal Register, not one of them had lawful power to act. These are the citations: (1) *Federal Crop Insurance Corporation* v. *Merrill* (Supreme Court 331, U. S. 798; 332 U. S. 380). The Government regulation of delegation of authority was published in the Federal Register. Because it was published, the Supreme Court decided in favor of the Government. (2) *Steven Hotch* v. *United States* (U. S. C. C. Appeals 9th Circuit No. 13621, Dec. 2, 1953). The Court of Appeals remanded and dismissed. Reason: The regulation was not published in the Federal Register.

ADDENDUM NO. 2

1. This is a discussion of interest on deficiency tax assessments.

(*a*) Section 292 of the Internal Revenue Code requires the computation of interest from the date the tax was due until the date when the assessment is made.

(*b*) A compliance with this law by the Commissioner produces this result: $45,204 28.

(*c*) A Form No. 7658—Statement of Income Tax Due—at February 1, 1949, was received by Kelley on or about February 2, 1949. The amount stated to be due was: $44,574.70.

(*d*) Did the Commissioner err in his computation?

(*e*) Did the Commissioner have in his custody at January 28, 1949, and thereafter, until on or about March 1, 1949, the proceeds of a deposit of Kelley's, transmitted under Kelley's letter dated October 8, 1948, to the collector of internal revenue?

(*f*) Did the Commissioner apply the proceeds to the full extent required of him by section 292, or did he fail to do so to the extent of $629.58?

(*g*) It is noted that Kelley's letter of October 8, 1948, refers specifically to his desire to learn from the collector the amount of interest, when determined to be due from Kelley. Kelley received no reply to his letter.

(*h*) Kelley's letter of October 8, 1948, transmitted not only money (check). There was transmitted also certain assignments for value. Representing cash credits to be applied in the adjustment of Kelley's liability. What was done with these cash credits when deposited with the collector? It looks like (1) the assignments were returned by the collector to the assignors, and (2) the money already assigned, and which was the property of Kelley under the assignment, was also refunded to the assignors. All of this was done while section 292 had not been complied with by the Commissioner.

ADDENDUM NO. 3

1. What in tax law is an overpayment as distinguished from a deposit?

2. Citations: *Hanley* v. *United States* (105 Ct. Clms., 638); *Roseman* v. *United States* (323 U. S. 655); *Herrick* v. *United States* (108 F. Supp. 20).

3. Facts.

4. On or about May 1946, again in September 1946, again in January 1947, again in September 1948, the Government's letters and forms and notices and oral advices to Kelley formed a pattern. There was a contingent liability in terms of Government's feeling that it should make a deficiency tax assessment for the tax years 1941, 1942–43, and 1944.

5. On or about September 1948, a final notice was received by Kelley, a 90-day letter. Either deposit the proposed contingent tax liability before it became an actual liability in terms of a signed assessment roll, or take the matter to the Tax Court within the time allowed by statute. Kelley did neither thing. Kelley remitted to the collector a deposit under a letter of transmittal, in which he stated his reasons for making this deposit.

6. On or about January 28, 1949, the Acting Commissioner signed an assessment roll on which was an assessment of Kelley for the year 1943. The collector, on or about February 1, 1949, sent Kelley a statement of income tax due, year 1943, showing Kelley what he owed, and Kelley remitted to the collector.

7. Thereafter Kelley was advised by the collector of the payment of the year 1943 deficiency tax assessment on or about February 11, 1949.

8. Kelley's claims for refunds of year 1943 overassessment are dated: (1) March 21, 1949, (2) January 2, 1951; (3) September 24, 1952; this being, as stated in claim, the perfection of the previous claims filed on year 1943.

9. The Government contends that it cannot find the claim filed March 21, 1949; that the claim filed January 2, 1951, was filed more than 2 years after the deposit of October 1948 was made by Kelley with the collector; and section 322 (b) of the Internal Revenue Code does not permit the Commissioner to refund the October 1948 deposit owing to dictum in the case of *Hanley* v. *United States* (105 Ct. Claims 638).

10. About the cases of (1) Hanley, of (2) Rosenman, of (3) *Herrick* v. *United States*, these cases are claims for refunds and/or payments of interest on deposits and/or overpayments of tax. These cases have been cited to taxpayer Kelley during the discussions with lawyers, including the lawyer representing Government.

11. The Current Tax Payments Act of 1943, section 4 (d), is referred to in report of Senate Finance Committee, Report No 221, 78th Congress, 1st session, at page 34. The committee clearly indicates that section 4 (d) was inserted so that the Commissioner of Internal Revenue would not be in position to deny interest on overpayments made in good faith. The committee also noted that there had been some court decisions which could be interpreted to hold that where there was no liability there was no overpayment. The committee went on to say, at page 34:

"In the view of your committee, the code does not contemplate that liability for interest can be cast on the Government by merely dumping money as taxes on the collector, by disorderly remittances to him of amounts not computed in pursance of the actual or reasonably apparent requirements of the code, or not transmitted in accordance with the procedures set up by the code, or by abuses of tax administration. As to these, your committee believes that a proper application of existing law will enable the courts, in the future as generally in the past, to deny treatment as overpayments to these improper payments."

12. The information to taxpayer Kelley from the Government pertinent to this Senate Report 221 is that the intent of the Congress seems very clearly stated; but, because of the dictum (only) in the case of *Hanley* v. *United States* (105 Ct. Claims 638), which is now the latest law found for the case of Kelley, the Government cannot act within the scope of the plainly stated intent of the Congress stated in the Senate Report 221, but is compelled to reject that intent and accept the dictum under which the claim for refund of the deposit made by Kelley must be rejected.

13. Kelley contends that he did not and he could not "pay" what was merely a contingent item in October 1948. He contends that his deposit was the result of his honest mistake with respect to the requirements pertinent to interest computations and charges on deficiency tax liabilities when later created by a commissioner's assessment roll. His mistake was in not knowing that the regulations allowed him to mitigate interest on tax liability when created unless he did make a deposit of an amount that was reasonable.

(*a*) The collector received the deposit. He placed it in a suspense account to await the outcome of a recommendation of the internal revenue agent in charge to Washington that a deficiency tax assessment be made. Kelley contends further that he paid this tax on February 11, 1949, the date when the collector took the deposit from suspense account and applied the money to the payment of the deficiency tax stated on the assessment roll signed by the Commissioner.

(*b*) In support of his contention, Kelley cites the case of *Rosenman* v. *U. S.* (323 U. S. 655). Kelley does not believe that the case of *Hanley* v. *U. S.*, hereinabove referred to, reversed Rosenman. And Kelley also cites the case of *Herrick* v. *U. S.* (108 F. Supp. 20), where the Commissioner himself argued that a similar deposit was not payment of the tax—even when the Commissioner had deducted the same from the amount in assessing a deficiency. In this case, the United States District Court for the Eastern District of New York, in deciding that the payment was made when credited by the Commissioner, affirmed that the Rosenman case was controlling.

(*c*) Section 4 (d) of the Current Tax Payments Act, which amended section 3770 of the Internal Revenue Code by adding at the end thereof paragraph (c):

"(c) RULE WHERE NO TAX LIABILITY.—An amount paid as tax shall not be considered not to constitute an overpayment solely by reason of the fact that there was no tax liability in respect of which such amount was paid."

means, according to the Hanley case dictum that Congress intended this law to place all deposits made in good faith under the then existing law under this 4 (d) amendment. Kelley disagrees, believing that the then existing law applies to his October 1948 deposit.

14. Out of the taxpayer's experience in his work with the employees of the Internal Revenue Service, including employees at top level, comes this thought for the improvement of tax administration:

To the businessman accustomed to assuming responsibility for his own decisions, it is amazing to meet so many Government employees engaging in claims-adjustment work with taxpayers who fear, apparently, to assume full responsibility for a flat recommendation that favors the taxpayer. Even after the merit of the taxpayer's claim is conceded; when it is known and, without equivocation also, that money has been unlawfully collected; when there are, say, 12 laws and 12 regulations favorable to a recommendation for the allowance of the claim, as opposed to some remote application of some one law or of some one regulation unfavorable to allowance of the claim; it has been this

taxpayer's experience that he will be compelled to overcome strong resistance on the part of Government personnel that will use the unfavorable law or regulation, as construed by the personnel, even though doing this thing is almost certain to depreciate good public relations and create forms of criticism and contempt for tax administration. One may wonder why it is that a Commissioner has not, long, long ago, required each and every one of this personnel to furnish a clear statement of his or her belief that ours is a Government of laws, and not a government of men, under which the doubt shall be resolved in favor of the "defendant" taxpayer.

The same businessman also comprehends that the job of the man who proves unwilling to assume the responsibility for his own opinions when favorable to the taxpayer comes first in the thinking of such an employee. However, on the other hand, is it true that more than 20,000 claims in the courts have a source pertinent to the refusal of employees to assume responsibility, even at top level, where litigated cases come for review and decision?

ADDENDUM NO. 4—SECTION 3770 (C) OF THE INTERNAL REVENUE CODE

1. This is discussion with reference to section 4 (d) of the Current Tax Payments Act of 1943. This is section 3770 (c) of the Internal Revenue Code. In the case of *Hanley* v. *United States* (105 Ct. Claims 638), the dictum of the court has been cited to Kelley.

(*a*) Question: What is "dictum"? In law, it is a judicial opinion expressed by judges on points that do not necessarily arise in the case, and are not involved in it, or one in which the judicial mind is not directed to the precise question necessary to be determined to fix the rights of the parties. Dictum does not have the binding force upon subsequent or inferior courts that is accorded to an adjudication.

(*b*) The word "solely". Exclusively; to the exclusion of all other things, as "done solely for money." Section 3770 (c) includes the word "solely." Kelley did not make a deposit with the collector during October 1948 "solely" because he had no tax liability. The congressional committee reports pertinent to section 4 (d) of the Current Tax Payments Act of 1943 make it abundantly clear that it was of the opinion of the lawmakers themselves that existing law was sufficient. The only reason, as the lawmakers clearly stated in their reports, for an amendment was to stop the disorderly "dumping" of money "solely" for the purpose of collecting interest on such money. Certainly, the facts, which have been submitted, pertinent to the Kelley deposit make it clear that 3770 (c) does not deny Kelley a refund of his deposit.

(*c*) Rule where no tax liability:

1. "An amount."
2. "Paid." Kelley did not pay until February 1949.
3. "As a tax." His deposit in October 1948 was not a tax payment.
4. Shall not be considered.
5. Not to constitute.
6. An overpayment.
7. Solely by reason of. His deposit was not made solely for the reason he had no tax liability.
8. The fact that there was.
9. No tax liability in respect. He did have a tax liability.
10. Of which.
11. Such.
12. Amount was paid. He paid it after January 28, 1949, on a date after the Commissioner assessed him. His payment after the Commissioner assessed him was made during the period of 2 years immediately preceding the filing of his claim for refund of overpayment of his 1943 tax. Section 322 (b) of the Internal Revenue Code provides for the refund of his overpayment.

1. Question: On what date was the overpayment made for the year 1943? If Kelley had a liability at the date when he made a deposit with the collector, then section 3770 (c) need not be considered.

2. Question: What is a liability?

(*a*) It is the state or quality of being liable.

(*b*) Accounting. A debt; an amount which is owed, whether payable in money, other property, or services.

(*c*) A contingent liability is an amount resulting from past transactions which may become a liability in the future under certain defined circumstances.

(*d*) A current liability is one which arises—and must be met usually in not over a year * * *. And in this current liability are such things as accruals of interest or taxes.

(*e*) "Liable." Bound or obliged in law * * * as, all his property is liable to pay his debts, and to taxes.

(*f*) Accrued liability. Such as, for example, interest that had accrued from March 15, 1944, to September 1, 1948—the date of the proposed deficiency "determination" of Kelley's tax liability.

3. Question: What is considered to be evidence of Kelley's contingent liability?

(*a*) At September 25, 1946, a notice in writing from the Government to Kelley was mailed to him. This notice informed him that an examination warranted this notice to him. Enclosed with the notice was an explanation in detail, setting forth a proposed contingent liability. There was also enclosed with the notice a form of agreement, to which the notice referred. This form is No. 870. As described in the notice to Kelley, should he sign and return this form, no later than 30 days after September 25, 1946, he would be entitled to receive such benefits in terms of mitigation of an actual liability of costs for interest as was provided in the tax laws. The law is cited in the form, section 272 (a) and section 272 (d) of the Internal Revenue Code.

(*b*) Kelley did not sign the form 870. He did not make any payment.

(*c*) At January 8, 1947, Kelley and the Commissioner executed an agreement. This is form No. 872. This agreement extended the time in which the Commissioner might assess Kelley. This agreement expired on June 30, 1948.[1]

(*d*) At September 1, 1948, a second letter was mailed by the Government to Kelley. This was a final notice to him of a proposed contingent tax liability. He was informed that he must do one of two things, failing which a proposed contingent liability would mature, immediately, an actual liability. Again, he received a form, No. 870. Again, Kelley did not sign this form. Again, Kelley made no payment.

ADDENDUM NO. 5

1. This refers to a claim dated March 21, 1949.

(*a*) Question: What, for the purposes of the tax law pertinent, is a claim? In order to comply with the tax law, does the law require the filing of a claim, using only form 873? And, if the law does not require this, has there been, perhaps, the overlooking of the word "apprise"? Or, in other words, did Kelley apprise the Commissioner and to the extent that the Commissioner was informed about the contentions of Kelley?

(*b*) When Kelley received a letter from the Government, dated September 25, 1946, he replied. In his reply, he did apprise the Commissioner, and in detail. His reply took the form of a protest; a declaration by Kelley to the Commissioner in which Kelley asserted his rights and claims.

(*c*) Kelley, again, when he received a letter from the Government dated September 1, 1948, made his reply. Again his reply took the form of a protest. Again Kelley asserted his rights and claims.

(*d*) During the period beginning with the Government's letter dated September 25, 1946, until a date in August 1953, a period of 8 years, the protests and claims of Kelley were in motion between the Commissioner and Kelley.

(*e*) During July 1953, a conference, in which Kelley participated, in the office of the Appellate Division of the Internal Revenue Service, resulted in a tentative proposal presented to Kelley. Unless the Appellate Division had, at this time, recognized an overpayment by Kelley for an amount not less than the amount stated in the claim dated March 21, 1949, such tentative proposal for settlement would not have been presented. Furthermore, as understood by Kelley, the proposal, in that part of it that was pertinent to the year 1943, would use in the channel of bookkeeping items certain overassessments of related taxpayers (2) to set off. The result, as it was explained to Kelley, would be that there was no "overassessment" for the year 1943.

Sufficiency of claim filed

1. The firm of H. E. Kelley & Co. was organized December 31, 1940. This, a partnership, owned by five people, commenced business on January 1, 1941. Legal counsel for the partnership handled and fulfilled the requirements for

[1] Before this agreement expired, Kelley and the Commissioner executed a similar agreement at March 15, 1948. This agreement expired June 30, 1949.

partnership under the laws of the State of Virginia. This partnership business has continued since organized.

2. May 20, 1946: Notice to Kelley, tax liability year ended December 31, 1941.

3. September 25, 1946: 30-day letter to Kelley, tax liability 1943 and 1944.

4. October 21, 1946: Protest by Kelley against the assessment of the proposed tax liability.

5. January 8, 1947: Agreement executed by Kelley with Commissioner Nunan (by "CAGD") to extend the time for assessment.

6. June 11, 1947: Tax Court decision on year 1941 tax liability.

7. January 23, 1948: Protest by Kelley against proposed assessment years 1942, 1943, 1944.

8. January 1948: Exchange of letters between the taxpayer and internal-revenue agent in charge. Letters are dated November 26, 1947, December 5, 1947, January 7, 1948. References are made to protests filed by the taxpayer.

9. July 27, 1948: Taxpayer to technical staff. "Claims" before the technical staff.

10. September 1, 1948: Ninety-day letter. Proposed assessment. Years 1943 and 1944. (Waiver form No. 870 was sent with this letter; no waiver was executed by the taxpayer.)

11. September 4, 1948: Taxpayer's agent, Edmondson, letter to Kelley. Year 1943. The tax agent instructs the taxpayer on procedure for the filing of a claim for refund of a tax paid.

12. October 2, 1948: Taxpayer to tax agent. Taxpayer advises agent $50,000 will be borrowed; a check will be prepared and sent the tax agent for transmittal to the collector of internal revenue. Taxpayer states, in pertinent part, "I understand we are paying this under protest * * * If there are any questions, call me." (The tax agent's power of attorney is on file with the Internal Revenue Service.)

13. October 4, 1948: National Bank of Commerce to taxpayer acknowledges receipt of note for $50,000 and advises proceeds have been credited.

14. October 8, 1948: Tax agent to collector of internal revenue. A letter. A deposit is made; $42,643.63. Letter states that the deposit was "herewith to cover." And "an additional remittance" will be forwarded to cover interest. And "to prevent the further accumulation of interest * * *." And "to file refund claims" and "for recovery of * * *, if necessary, * * *." (No assessment had been made yet. Consequently, this was a "deposit" to cover a contingency in the future.)

15. February 1, 1949: Collector sends statement of tax due (form 7658). Year 1943.

16. February 3, 1949: Check, $1,931.07, sent to the collector, to adjust and complete the adjustment of tax liability for the year 1943.

17. February 8, 1949: Letter, taxpayer to collector, refers to years 1943 and 1944. Taxpayer inquired about the distribution of his deposit under his letter of October 8, 1948. Taxpayer had received no acknowledgment of the deposit, and did not know that the distribution would be different than stated in the transmittal letter. (The collector's silence during the period from October 8, 1948, until February 1, 1949, covers a period of time during which the taxpayer—had taxpayer been notified by the collector that his distribution would not be made—could have taken appropriate steps against the toll of a statute of limitations pertinent to section 322 (b) of the Internal Revenue Code.)

18. March 21, 1949: A claim was filed: $42,643.63. Claim refers to a protest on October 8, 1948. Refers to transmittal letter of October 8, 1948.

19. March 22, 1949: Until November 1950. During this period, discussions, together with correspondence between taxpayer, taxpayer's agent, and the Internal Revenue Service were in motion, as indicated in the files of both parties.

20. During April and May 1950, the taxpayer and his agent were together in the offices of the Internal Revenue Service, Richmond, Va., for the purposes of stating the taxpayer's claim and asking for the refund of the overassessment. (These dates occur during the period from October 8, 1948, the date of the taxpayer's deposit with the collector, and 2 years later, at October 8, 1950. Consequently, this fulfills the requirement that a claim shall be stated and a refund be asked for during the period of 2 years following the date of the deposit.)

21. January 2, 1951: A claim for $1,931.07. Year 1943.

22. September 24, 1952: A claim; $34,975.96. This claim, as very clearly stated therein, was to perfect the original claim. "2. The original claim followed payment of a deficiency in tax assessed by the Internal Revenue Bureau alleged

to be due for 1943 in its 90-day letter dated September 1, 1948 (Richmond division, Conf/MTM/MHB, after protest by claimant. The tax as assessed was paid by claimant, together with interest thereon as shown herein."

(This amended claim refers by reference to previous claims for the year 1943.)

(It should also be noted that the correspondence of the Government refers to and uses the word "claims," from which one must conclude that the Government recognized and was actually dealing with more than a single claim.)

23. April 14, 1953: Letter, internal-revenue agent to taxpayer. "The request for reconsideration of claim for 1943 sets forth the entire amount of 1943 tax deficiency assessed on September 1, 1948 (was not assessed until January 28, 1949, according to collector's statement of tax due, mailed to the taxpayer February 1, 1949) in the amount of $34,975.96." This is the Government's letter, stating that it had received a 1943 claim. Then, since it did receive a claim, for any amount stated, timely filed (Government states that the claim for $1,931.07 was received as timely filed), and also states the amount of $34,975.96 claim filed was considered, can there still be any question about the Commissioner having been apprised of a timely filed claim?

24. April 20, 1953: Letter, taxpayer to internal revenue agent in charge, requests that the claim matter be referred to the Appellate Division. This was the reply of the taxpayer to the letter referred to just above in No. 23.

25. July 14, 1953: Taxpayer, accompanied by three of his partners and their tax agents, met with the Internal Revenue Service in the offices of the Service in Richmond, Va. A technical adviser conducted the discussion for the Government. It was during this discussion that the taxpayer was informed that the partnership would be allowed for income-tax purposes. It was during this discussion also that the figure "$34,760.61"—overassessment for the year 1943—was recognized, was stated, was conceded, and was admitted to be the overassessment of the taxpayer; and this overassessment figure was used, and was taken into account by the Government and by the taxpayer for the purposes of settlement of the taxpayer's claim for the year 1943.

26. July 14, 1953: It was during the discussion referred to just above, No. 25, that the Internal Revenue Service settlement, as stated to the taxpayer, pertinent to the tax year 1943, included taxpayer's claim stated at "$34,975.96." Here again is a specific reference to such a claim filed, recognized, considered, reconsidered, and included in settlement factors by the Internal Revenue Service in discussion with the taxpayer.

(*a*) Basis for the claim (more than one claim is conceded by the Government) was the disallowance of the partnership. The claim filed September 24, 1952, for the year 1943, was considered as the application for reconsideration of claims for 1943. The overassessments resulting from allowing the partnership for tax purposes to be reduced by the amount of the refunds that were previously received by disallowed partners; such amounts to be applied so that there would be no overassessment for the year 1943. Again, one must ask: "Was the Commissioner apprised of the contentions of this taxpayer in terms of a timely filed statement of a claim, together with a statement that a refund of the overpayment was expected?"

27. July 16, 1953: Letter from taxpayer to Internal Revenue Service, Appellate Division. This refers to the discussion mentioned hereinabove, paragraph No. 26. This letetr states in detail the figures and the factors that were discussed in the July 14 meeting. Including the year 1943 overassessment of $34,975.96. And the letter states, "Please look this over and see if it coincides with the tentative agreement reached between your office and the claimant at the hearing held in your office July 14, 1953."

28. July 27, 1953: The taxpayer, with one of his partners and their tax agent, went to the office of the Internal Revenue Service, Appellant Division, in Richmond, Va., for the purpose of there and then completing settlement. At this time, the Internal Revenue Service informed the taxpayer his claim for the year 1943, amount stated $1,931.07, in which was stated the word "interest," was then "before me" ("me" meaning technical adviser), "but your claim for $34,975.96 is not before me, and I cannot consider it." The above was the gist of his statement.

(*a*) Following this statement to the taxpayer, the tax agent prepared new computations, in order to find out what the minus figure would be. This computation developed that if the taxpayer submitted to the proposition that the Internal Revenue Service's July 14 factor of $34,760.61 was now eliminated, merely because the claim was not then "before me," the taxpayer would get a

refund of approximately $16,000 for the year 1943, which would amount to a loss of approximately $18,000 for the taxpayer.

(*b*) It then developed that the Internal Revenue Service, following the July 14, 1953, discussion with the taxpayer hereinabove referred to at paragraph No. 25, did not find in its file a claim on which it had been conducting numbers of hearings, as well as informal talks with the taxpayer and/or his tax agent during the period from March 21, 1949, until a date after July 14, 1953. In plain English, the Internal Revenue Service didn't miss the claim until the time came for settlement. And when this happened and the taxpayer was informed about it, the taxpayer had less than 20 business days before the toll of a statute of limitations would forever bar a recovery of money due him by his Government. It was at this point that the burden was placed upon the taxpayer to start contacting various Government offices in Virginia, in Pennsylvania, in New Jersey, and in Washington, looking for what he was told by his Government was "the missing claim."

29. When the efforts of the taxpayer did not produce the missing claim, the taxpayer then discussed the problem in the office of the Commissioner of Internal Revenue, with the Deputy Commissioner, who referred the taxpayer to the head of the Technical Division, an Assistant Commissioner, who referred the taxpayer to the head of the Appellate Division, who suggested that the taxpayer take up his problems with the office of the Chief Counsel of the Internal Revenue Service. From that point on, the taxpayer made every reasonable effort to obtain a ruling equal to the job of getting a settlement before the statute of limitations had tolled at August 14, 1953.

(*a*) Taxpayer was unable to obtain the ruling and, in consequence, filed suit to protect his interests just ahead of the expiring date, on August 14, 1953.

30. Under the procedure of the Government, the filing of the suit placed the jurisdiction in the office of the Attorney General, where discussions have been continued with the taxpayer.

31. December 3, 1953: A lawyer for the Government pointed out, for the information of the taxpayer, the following situation:

(*a*) The tax year 1943 is subject to the Current Tax Payments Act of 1943.

(*b*) This act, as amended, appears under section 3770 (c) of the Internal Revenue Code.

(*c*) Section 3770 (c) is referred to in the case of *Hanley* v. *United States* (U. S. 105 Ct. Claims 638). The dictum of the court is regarded by the lawyer for the Government as the latest law that he has been able to find applicable to the case of Kelley, the subject taxpayer and, under this dictum, as construed by the lawyer, his hands are tide to the proposition that a deposit that was made by Kelley at October 8, 1948, was not a deposit, according to this dictum, but was a payment of a tax. The payment of a tax more than 2 years previous to the filing of a claim places such a payment under section 322 (b) of the Internal Revenue Code.

32. Section 322 (b) of the code is the law on refunds of overpayments. This law, in effect, does not permit the Commissioner of Internal Revenue to refund the deposit of this taxpayer, made October 8, 1948, only because the dictum in the Hanley case has been construed by the Government to mean that any deposit, whether made in good faith or made in bad faith, whether made because of an honest mistake on the part of the taxpayer in respect to his understanding of a tax liability and/or the amount of a tax liability, actual or contingent, or, in fact, under any circumstances whatsoever, shall be classified for income-tax purposes as the payment of the tax.

33. The lawyer does not question this dictum, for it is, he says, the latest law he can find.

34. A report of the Senate Fnance Committee about section 3770 (c), when read, makes it crystal clear that it was never intended to apply to a deposit made in good faith as the result of an honest mistake on the part of a taxpayer.

35. The Government, in regard to other claims of this taxpayer for the refund of overpayments of tax for the years 1943 and 1944, takes the position that it will not concede that such refunds are due the taxpayer while that portion of the overassessment for the year 1943 that is in controversy, thanks to the dictum in the Hanley case, remains unsettled. This position of the Government leaves to the taxpayer nothing worth considering, unless and until the taxpayer has persuaded his Congressman to put a private bill in the mill on the Hill for the purpose of refunding to this taxpayer money that is due him.

Meanwhile presenting to the members of the Ways and Means Committee a copy of this statement of information, which so clearly indicates a need for legislation for the clarification, including the definitions pertinent to the words "deposit," as distinguished from "payment."

ADDENDUM NO. 6

1. This is a discussion pertinent to what has been called "That is our policy, Mr. Taxpayer."

(*a*) Section 322 of the Internal Revenue Code provides for the refund of the overpayment of a tax.

(*b*) If, as has been stated many, many times, this is the law, then the question raised is this: Who had the power to make policy to the contrary?

(*c*) The said policy in its practical application retains money determined to have been overpaid to the Government; money that the law requires be refunded, and yet a taxpayer hears this: "Yes, Mr. Taxpayer; you did overpay your tax $1. Yes; you are entitled by law to a refund of $1. But nobody ever gets it all back. That is our policy. And, anyhow, Mr. Taxpayer, should you decide to go to court to try to get it all back, as provided by law, your proceeding would be expensive, as you probably know that legal services require not only a substantial retainer, but, as a rule, it is also required that you share the proceeds of any award with counsel. We, here in the Internal Revenue Service, require the filing with us of agreements executed by taxpayers with their legal counsel where contingent fees are included in such agreements. We, therefore, know that such contingent fees are rarely ever less than 15 percent of the amount of an award, and that these fees rise as high as 33⅓ percent of an award."

(*d*) It may be noted that a congressional committee investigation of the tax administration, completed in 1953, and a report of the investigation made, includes that which is pertinent to our policy. And it is indicated that a cease and desist will follow. It may be recalled that the Supreme Court of the United States has stated: "Arbitrary power and the rule of the Constitution cannot both exist."

YALE UNIVERSITY LAW SCHOOL,
New Haven, Conn., April 19, 1954.

Senator EUGENE D. MILLIKIN,
Senate Finance Committee, Washington, D. C.

MY DEAR SENATOR MILLIKIN: I note that a group of representatives of the Joint Congressional Committee on Internal Revenue Taxation and of the Treasury has been created to consider technical criticisms of the proposed Internal Revenue Code of 1954. This is a desirable step, but I venture to predict that not even the typographical errors in the bill and the committee reports will be corrected in the brief time allowed. It seems to me incredible that a bill of this importance is to be voted on before the bar has had a fair opportunity to study it with care.

Let me call your attention to only two problems that arise under one of the simplest of all its provisions: Section 117, dealing with scholarships and fellowship grants. Under this provision, a student who is required to perform "teaching or research services in the nature of part-time employment" for his scholarship or fellowship grant will be taxed on that part representing payment for such services. There is no such disqualification for services other than teaching and research. This seems to mean that a student may receive a tax-free scholarship if he has to cut the grass to hold it, but not if he is required to teach a laboratory session. This suggestion is so fantastic that it immediately occurs to me (as I am sure it will occur to the Internal Revenue Service) that a scholarship conditioned on the student's cutting the grass is either (a) not a scholarship at all, or (b) not a scholarship to the extent of the value of the grass-cutting services. The latter suggestion would put the grass-cutting student on a par with the teaching student. It also illustrates the ambiguity of the proposed new section.

Secondly, section 117 provides in substance that a fellowship grant (received by one who is not a candidate for a degree) shall be excluded from income unless it is 75 percent or more of his regular salary. Under this limitation, the fellowship grant is either fully taxable or fully exempt. The absurdity that results

from this restriction is amply illustrated by the example on page A38 of the House report. Because the individual there described received $450 from his employer, he has taxable income of $7,650. Had he not received the sum of $450 from his employer, the fellowship grant of $7,200 would be excluded from income. Section 117 (b) (2) of the proposed new law has the precisely same effect as the gross income restriction applied to dependents by section 25 (b) (1) (D) of the present law, a restriction which has been criticized and revoked by the draftsmen of the new code.

These comments do not by any means exhaust the ambiguities or difficulties that lurk in section 117; and even a casual reading of parts of the proposed code demonstrates that similar problems arise under many other sections. I very much fear that, if enacted, this bill will be long-remembered as a monument to the dangers of action without full and fair discussion.

Yours respectfully,

BORIS I. BITKER.

ST. PAUL ASSOCIATION OF COMMERCE,
St. Paul, Minn., April 19, 1954.

Hon. EDWARD J. THYE,
Senator from Minnesota, Senate Office Building,
Washington, D. C.

DEAR SENATOR THYE: It is our understanding that the proposed Internal Revenue Code of 1954 (H. R. 8300, the tax-revision bill) is now under consideration.

This section provides for the declaration of estimated income and advance payments of corporate income taxes.

Under the provisions of this section a corporate taxpayer in the ninth month of each taxable year will file a declaration of its estimated income for that year and make a payment of a part of the tax due. A second advance payment will be due in the 12th month of each taxable year, with the balance of the tax due payable in the 3d and 6th months of the following year. The advance payments will each be 5 percent of the estimated tax in the first year of operation, 10 percent each in the second year, and so on, until, when the plan is in full operation, there will be 4 payments of 25 percent each. The attached example shows the operation of the plan from start until it becomes fully effective.

You will see from the example that in each of the 5 years which it takes to put the plan into operation the corporate taxpayer will, in effect, be paying 110 percent of the annual tax bill, so that when the transition period is complete the taxpayer will have paid to the Government an amount equivalent to one-half year's tax bill. This advance can never be recovered unless the taxpayer liquidates and goes out of business. This 110 percent comes from the fact that in the first year of operation the taxpayer will pay the previous year's taxes in 2 installments of 50 percent each in the 3d and 6th months of that year, and then in the 9th and 12th months the first advance payments will be due.

DISADVANTAGES OF THE PLAN

There are two major disadvantages to the plan:

First, all corporations which will be subject to the plan (corporations with an anticipated tax liability of more than $50,000) will, in effect, have to sacrifice working capital to pay taxes, and will, at the end of 5 years, have lost working capital equivalent to one-half year's tax bill. This is a substantial loss.

If working capital is not sacrificed, the corporation must find the money from other sources. Some publicly held corporations may be able to do this by selling additional securities, but many of the closely held family type retail corporations may have to abandon plans for expansion, etc., in order to meet the increase.

The second reason is more or less peculiar to retailing. A great number of retail corporations have their most profitable season at Christmas and make a large portion of their sales in November and December. These corporations will have to make their first estimate in advance of any indication of what sort of a Christmas business they are going to have. Their second estimate will come just before inventory and it, too, will be more or less a guess.

Operation of section 6016, Internal Revenue Code of 1954, providing for declaration of estimated income with advance payments

(Example: Retail corporation with a fiscal year ending January 31: Annual volume $5,000,000; net income before Federal taxes, $250,000, Federal income tax $124,500.)

Year	Payments made in fiscal year ending				
	From previous year's income			From current year's income	
	April	July	October	January	Total
1956	62,250 (50 percent)	62,250 (50 percent)	6,225 (5 percent)	6,225 (5 percent)	136,950 (110 percent)
1957	56,025 (45 percent)	56,025 (45 percent)	12,450 (10 percent)	12,450 (10 percent)	136,950 (110 percent)
1958	49,800 (40 percent)	49,800 (40 percent)	18,675 (15 percent)	18,675 (15 percent)	136,950 (110 percent)
1959	43,575 (35 percent)	43,575 (35 percent)	24,900 (20 percent)	24,900 (20 percent)	136,950 (110 percent)
1960	37,350 (30 percent)	37,350 (30 percent)	31,125 (25 percent)	31,125 (25 percent)	136,950 (110 percent)
1961	31,125 (25 percent)	31,125 (25 percent)	31,125 (25 percent)	31,125 (25 percent)	124,500 (100 percent)

NOTE.—Example was made on assumption that the taxpayer would pay the full amount in the advance payments in October and January. Actually, the advance payments are based on a percentage of anticipated tax liability in excess of $50,000. If the taxpayer took advantage of this provision, which would be probable in most cases, the advance payments would be reduced and the payments in the following year increased accordingly.

We will appreciate your cooperation very much in opposing this particular portion of the tax bill which we believe without question is very adverse to the interests of our retailers, not only in St. Paul, but throughout the country.

Respectfully yours,

M. W. THOMPSON, *Retail Secretary.*

STATEMENT OF L. SHIRLEY TARK FOR BANKERS COMMITTEE FOR TAX EQUALITY

My name is L. Shirley Tark. I am president of the Main State Bank of Chicago and speak as a representative of the bankers' committee for tax equality, a committee of the National Tax Equality Association which numbers among is membership some 4,000 banks engaged in the commercial and savings fields and located throughout the United States. The banks I represent are in direct competition with savings and loan associations, mutual savings banks, credit unions, and other cooperative financial institutions that are now receiving favored tax treatment. They wish to call to your attention the injustice of the present situation, and to urge that the present tax exemptions and the excessively large reserves permitted savings and loan associations and mutual savings banks for tax purposes, be modified or repealed so that the income of these institutions will be taxed in the same way as that of the banks that compete with them.

This is not my first appearance before you on this subject. On July 11, 1951, I appeared before you to point out that the then existing tax exemption enjoyed by savings and loan associations and mutual savings banks permitted them to compete unfairly, and to the disadvantage of, commercial banks. At that time I was particularly interested in demonstrating that the theory that these organizations had no taxable profits because of the mutuality of their operations had no basis in law and that they were in fact engaged in business for profit and were competing with other taxpaying financial insitutions.

Subsequently, the provisions granting tax exemption to savings and loan associations and mutual savings banks were revoked by the Revenue Act of 1951. Unfortunately, however, the new law contained a reserve formula so generous in its scope that even without a tax-exempt status, almost all savings and loan associations and many mutual savings banks continued to earn income and to escape income taxes. The tax status of credit unions, production credit associations, and national farm-loan associations was not changed by the act.

Although the Revenue Act of 1951 taxed the corporate profits of savings and loan institutions and mutual savings banks, it permitted them to deduct

from income as a reserve for bad debts any amount which did not bring total reserves to more than 12 percent of share or deposit liability. At the close of 1949 the average reserve of all savings and loan associations was only slightly more than 7.5 percent of the savings invested. From the close of 1949 to the close of 1953, total savings moved from $12¼ billion to nearly $23 billion. As a consequence of the tremendous growth of these organizations, their reserves at the end of 1953 were 7.1 percent of total assets. In other words, although enjoying year after year of tremendous prosperity with earnings rising from approximately $450 million in 1949 to $700 millions in 1952, savings and loan associations are now farther than ever from being required to pay any Federal income tax.

The same holds true of mutual savings banks. At the close of 1950 the reserves for all mutual savings banks averaged 11.4 percent. Due to their rapid growth, at the close of 1953, their deposit liability was up to nearly 24½ billions and their reserves were down to 10.5 percent. The mutual savings banks earnings have risen from approximately $450 million a year in 1949 to $630 million in 1952. They are also, therefore, farther away from being required to pay Federal income taxes now than they were at the close of 1950.

Spokesmen for these organizations claim that they represent the efforts of a few "little" people who pool their "meager" earnings in an effort to get enough money to build homes for themselves. That may have been true many years ago, but today these organizations represent "big business" as they themselves admit (see article by Norman Strunk, p. 34, Burroughs Clearinghouse for Bank and Financial Officers, April 1954). To cite a few examples, along the east coast we have in Washington the Perpetual Building Association, a savings and loan association with assets of $168 million. The Baltimore Federal Savings & Loan Association of Baltimore, Md., has assets of nearly $91 million. Turning to the Midwest, Chicago has the First Federal with assets of $142 million, the Bell Savings & Loan with assets of $123 million, and the Talman Federal with assets of $103 million. The Twin City Federal in Minneapolis has assets of $148 million.

Proceeding west, we have the Farm and Home Savings & Loan Association of Nevada, Mo., with assets of $109 million. Along the Pacific coast we find the Pacific Coast First Federal of Tacoma, Wash., with assets of $106 million, the Home Savings & Loan of Los Angeles with assets of $136 million, and the Coast Federal of Los Angeles with assets of over $166 million.

It is clear that at the present time savings and loan associations are organizations with large assets which control vast concentrations of economic power, yet present tax laws are so drawn that they are required to contribute little or nothing in the way of income taxes to the support of the Federal Government.

One result of their large accumulations of wealth may be found in the multi-million-dollar buildings that they are erecting—usually in center of town. I suggest you walk into the lobby of the multi-million-dollar home of the Perpetual Building Association here in Washington. Its luxurious lobby and the electrically operated vertical nylon venetian blind that is 200 feet long on one wall are wondrous to see. I could refer you to the ultramodern furnishings and design of the new quarters of the Peoples Federal in Monroe, Mich., or the new "circular design" quarters of the First Savings & Loan Association of Cumberland, Md., or the impressive new headquarters of the St. Petersburg Federal in Florida, etc. Such fine edifices are being paid for by these institutions out of profits that the commercial banks are required to use to pay income taxes.

What are the consequences of the tax favoritism now extended these institutions? The tax-favored group consisting of about 30 percent of all savings institutions gets nearly 70 cents of every new savings dollar. Since World War II the savings capital of all savings and loan associations in the United States has increased at a rate of 466 percent times that of all commercial banks.

The banks that I represent are aware of the inevitable outcome of the tax-subsidized competition they are now facing. I believe that some of the Senators who gave this matter serious thought in 1951 are also aware of what will happen if the building and loan associations and mutual savings banks are permitted to continue to operate on what is actually a tax-free basis, since the taxing formula produces no tax.

Senator Kerr on September 21, 1951, during a debate on this matter in the Senate, stated the matter clearly when he said (Congressional Record, p. 12083):

"Their position relative to the commercial banks is changing so rapidly that as of today I would say they have half as much earnings as do all the commercial banks in the United States. If we permit the mutual savings banks and

the building and loan associations to continue to be tax free, the day is not far distant when their profits after disbursements will exceed those of the commercial banks. When that happens, the profits after disbursements of the mutual savings banks and the building and loan associations, instead of being a mere 3 or 5 percent of what those of the commercial banks were a few years ago, will be, instead, I would say, approximately 20 percent or 25 percent of those of the commercial banks; and they will replace the commercial banks, because the commercial banks cannot pay a 52-percent tax on their profits and have their competitors pay nothing, and continue to survive."

Senator Kerr also said (Congressional Record, p. 12081):

"If we leave them tax exempt, the day will come when they and the other tax-exempt organizations will have all the money in the country. Glory be."

Just as Senator Kerr pointed out that commercial banks could not "continue to survive," Senator George pointed out during the debate on the matter the following day that "the power to exempt one group from taxation and to put the burden on another is the power to destroy the group which is taxed" (Congressional Record, p. 12120).

The banks I represent see savings and loan associations and mutual savings banks growing at a tremendous rate and building modern, luxurious quarters for themselves in order to attract the savers of the community into their offices. They see an ever-growing portion of the savings dollar being taken away from them by these institutions with no possibility on their part of ever getting it back as long as the present tax favoritism continues to exist. They have been hurt and they are being hurt more and more by this inequitable tax law, and they beg you to take immediate action to correct it.

There is no reason for continuing the tax-exempt status of approximately 14,398 credit unions in the United States that are competing with taxpaying institutions. Like all other tax-free enterprises, credit unions have shown a startling growth during recent years. In the last 5 years their number increased 54.3 percent. Their assets increased from $192 million at the close of 1939 to over $2 billion at the close of 1953.

As of June 30, 1953, there were approximately 500 production credit associations in the United States having combined assets of $931 million. These associations had $86 million in surplus funds accumulated out of net income. On their 1952 earnings of over $9,956,000, they paid a total income tax of only $1,468,000. In other words, their average rate was less than 15 percent, as compared to the 52-percent rate being paid by the private banks with which they compete.

National farm loan associations, which provide long-term loans to farmers, numbered more than 1,155 at the close of the 1953 fiscal year. They had combined assets of $129 million and capital stock outstanding in the amount of $70 million. Their reserves and surplus approximated $53 million. Their earnings for the 1952–53 fiscal year amounted to over $9 million, upon which no Federal income tax was paid.

There can be no question about the ability of these financial institutions to pay taxes on their profits the way other corporations do. We are not arguing that these organizations should not have reasonable reserves to protect them from the recessions that periodically appear in our economic activity. The commercial banks have reserves too, but they are not allowed to compute them under a formula so generous that they escape paying income tax altogether. Why should not these savings and loan associations and mutual savings banks be allowed to set up reserves on the basis of the demonstrated need for such reserves as is the case with commercial banks? If that is not satisfactory, then I suggest that the 12-percent figure be lowered so that it will come more in line with the realities of the situation.

I believe the hope should be realized which was expressed by your chairman during the 1951 Senate debate, when he said (Congressional Record, September 22, 1951, p. 12138):

"It has been my own hope that we could arrive at something which would not allow the profits of these institutions, which are in excess of the amount needed to protect their security, to be exempt from taxation; I hoped that they would be subjected to taxation, and I believe we should not allow them to be free from that kind of taxation."

In spite of the hopes expressed by Senator Millikin, the bill that actually passed has failed to bring about the needed taxation. It is clear that the figure of 12 percent must be lowered if the desired objective is to be reached.

Perhaps some light can be thrown on what the proper percentagee should be by considering the reserve requirements set up by statute, for the Federal

Savings and Loan Insurance Corporation in order to provide adequate insurance coverage for accounts in insured members of savings and loan institutions. The statute (12 U. S. C. A., sec. 1727) requires a premium charge to be paid by the institution equal to one-twelfth of 1 percent per annum of the insured accounts until a reserve fund has been established that is equal to 5 percent of all insured accounts and creditor obligations.

The Federal Savings and Loan Insurance Corporation also requires an association applying for insurance to set up reserves adequate to absorb losses. According to the rules and regulations of the Corporation, an insured savings and loan association must allocate from its earnings at least three-tenths of 1 percent of its insured accounts to a reserve fund. This fund is to accumulate so that within 13 years it will equal at least 2½ percent of all insured accounts, and 20 years after the effective date of insurance the reserve has to equal 5 percent of all insured accounts. Should losses cause the reserve to fall below the required level, additional payments must be made thereto in order to bring it up to the 5 percent safety level.

The reserve requirements contained in State laws for State-chartered building and loan associations are also helpful in determining whether or not the 12 percent figure for reserve is too high. Some States, such as Delaware, Georgia, and Oklahoma have no statutory provision.

Arkansas requires 5 percent of earnings to be accumulated until the reserve fund equals 5 percent of assets. Kansas requirements are the same. Louisiana requires 3 percent of net earnings to be set aside semiannually until the reserve equals 5 percent of outstanding loans and real estate. In Nebraska, the reserve must equal 5 percent of total assets less cash, and in North Carolina the reserves must equal 5 percent of the paid-up outstanding stock. Pennsylvania requires a reserve equal to 5 percent of the assets.

The reserve requirements of Virginia are very interesting. The statute requires not less than 3 percent, or more than 15 percent of net earnings be put into the reserve fund until the reserve equals 5 percent of the total resources. The reserve may not exceed 15 percent of the total resources. I will not take up your time with reviewing the requirements of every State, but a review of the Federal and State requirements would indicate that a reserve of 5 percent was adequate and as indicated by the Virginia statute, a reserve of 15 percent is excessive. In view of these facts, it would seem that the present 12 percent reserve permitted for income-tax purposes permits these tax-favored institutions to escape income taxes and expand on tax-free profits until their reserves are nearly two and one-half times what might be called the reasonable reserve figure of 5 percent, and nearly reach the figure of 15 percent, which is considered excessive under Virginia law. It is no wonder that these institutions are able to expand year after year without reaching the point where they are required to pay income taxes.

I wish to make it clear that if the management of any savings and loan association wishes to have a reserve of 15 percent or 20 percent, that is their privilege and I have no objection to it, but it seems to me that after they pass the 5 percent reasonable figure, all additional profits kept in the corporation should be taxed the way other profits are taxed.

I realize that an institution with a 12 percent reserve is more secure than an institution with a 5 percent reserve, but I would point out that the same logic applies to the commercial banks, and indeed to all business organizations. That is not, therefore, a sufficient reason for allowing these organizations a greater reserve than experience would indicate as necessary. Savings and loan institutions and mutual savings banks are competing with the savings operations of commercial banks for the savings of the community and they both should be treated alike as far as tax-free reserves are concerned. In fact, they must be treated alike or else this overgenerous reserve privilege will be a tool that will ultimately destroy, for all practical purposes, the savings functions of the commercial banks.

The reserve for bad debts permitted commercial banks is based on their experience for the last 20 years, and since few banks have had losses during that period, the permitted tax-free addition to reserves in nearly all cases is less than 1 percent. Contrasting this to the 12 percent permitted savings and loan institutions and mutual savings banks brings to mind the statement made by Senator George during the Senate debate on this subject when he said (Congressional Record, Sept. 22, 1951, p. 12122):

"Obviously it would be a very unfair system of taxation which would permit one State to allow its commercial banks, let us say, to set aside 15 percent as a reserve, while another State allowed its commercial banks to set aside only 5 percent, and then for the Federal Government to say, 'We will tax all your profits above that reserve.'

"The fair and equitable thing to do is to have set up a uniform reserve which must be reasonable."

That "very unfair system of taxation" is exactly what we have now because of the different ways of calculating the permissible reserves for commercial banks as contrasted with savings and loan associations. All that the banks I represent are asking is that you correct this unfair system of taxation and set up a uniform reserve which will apply to all financial institutions.

The argument has been made that these very generous reserve provisions are necessary and should be continued in order to benefit the depositors in the case of mutual savings banks and the stockholders in the case of savings and loan associations. This point was well answered during the Senate debate by Senator Kerr, when he said (Congressional Record, Feb. 22, 1951, pp. 12142, 12413);

"I do not believe it is germane to this issue for Senators to argue that an additional reserve should be built up for the benefit of the depositors, because the depositors do not get the reserves. The only way the depositors can get the reserves is for the bank to be liquidated. And, Mr. President, tax-exempt financial institutions do not liquidate.

"In the case of the building and loan associations, the reserve is for the benefit of the stockholders. What stockholder would not want to have a provision in the Federal law that his institution should be the judge of how much of its earnings shall be tax exempt, until it accumulates as a reserve an amount equal to 10 percent of its total assets? No wonder the savings banks have increased nearly 100 percent in 5 or 6 or 7 years. If we continue to give them an exemption of their earnings at their discretion until their surplus is 10 percent of whatever their present or increased deposits may be, we shall have a magnet which will draw all the money out of the commercial banks into an institution which has a blanket exemption or freedom from taxation at the discretion of the institution itself, until its reserves equal and continue to remain equal to 10 percent of the amount of its expanding deposits.

"Mr. President, I know of a building and loan association with $150,000 capital. Inquiry was made about getting a little stock in that institution. The answer was received that 'stock is available in this institution at its book value of $3,500,000.' I looked into the situation to see how a corporation with $150,000 of capital could have a book value of $3½ million, and I found that it had been accumulating tax-free reserves. No commercial bank in the country can compete with that sort of an institution. My heart is not crying for the commercial banks, but I am aware of the fact that they have to pay taxes.

"I have heard Senators talk about the poor little savings and loan associations, the blessed little building and loan associations, and the little mutual savings banks. That is marvelous; but I call attention to the fact that in 1950 they made more than a quarter of a billion dollars, after all expenses, after the provision of all required reserves, and after all interest and dividends had been paid."

I submit that the reason the savings and loan associations are increasing their capital at a rate of 466 percent times that of all commercial banks is due to the fact that the 12 percent reserve privilege gives them a magnet which acts to draw all the money out of the commercial banks.

During the 1951 Senate debate on the subject, Senator Murray pointed out the fine character and good qualities of savings and loan associations, and seemed to conclude that they, therefore, should have special favors as far as the income-tax law was concerned. It seemed to me that this argument was answered very well by Senator George when he said (Congressional Record, Sept. 22, 1951, p. 12120):

"It seems to me that the Senator's statement, along with all the other statements which have been made, indicate the good qualities and character of these associations. Certainly they are good. The ordinary commercial bank is a good institution The railroads carried civilization across the continent, but they were taxed; and the commercial bank is taxed. All other business organizations are taxed. For some reason or other savings and loan associations and other institutions use the corporate form to do business. That they accumulate earnings is true beyond all peradventure of doubt. They may not be excessive earnings. I do not say they are. Undoubtedly any tax on them would be a burden on them, just as a tax is a burden on anyone else. It may have a

tendency to cut down their final net earnings, but so does the tax on everyone else cut down his possible net earnings.

"So I do not see why the Senator should be unduly alarmed because we want to impose a reasonable tax solely on the earnings, over and above a reasonable reserve."

In addition to the special reserve provisions enjoyed by savings and loan associations and mutual savings banks, section 23 (r), of the Internal Revenue Code, permits these organizations to deduct from earnings the dividends paid to owners. Although other banking corporations are required to pay full income taxes on profits, even though part of those profits are subsequently distributed as a dividend to the owners of the corporation, in the case of mutual savings banks, cooperative banks, and domestic building and loan associations, such dividends may be treated as deductions from gross income.

It has been argued that the stockholder of a savings and loan association is superficially like the depositor in a commercial bank and that, therefore, the share of the profits that he receives as a dividend should be treated by the savings and loan association as though it were interest paid on a debt.

It is obvious that the two are not in an identical status and treating them alike constitutes a gross error. However, if there is any similarity, it seems to me that only such similarity should be recognized by law The commercial banks are permitted to pay interest on their savings deposits in an amount not in excess of 2½ percent per annum. It follows that no deduction from earnings for the payment of interest may exceed 2½ percent. It is, therefore, respectfully suggested that savings and loans associations, and cooperative, and mutual savings banks be permitted to deduct as interest only the first 2½ percent of the profits that they distribute as dividends to their stockholders and depositors. That, I believe, is a fair compromise of this controversial issue.

In conclusion, it is recommended that the overgenerous reserve provisions contained in section 23 (k) of the Internal Revenue Code, be amended so that it will no longer constitute a loophole allowing practically all savings and loan associations and many mutual savings banks to escape all income taxes whatsoever. It is suggested that they either be required to determine their bad-debt reserves in the manner permitted commercial banks, or that the 12-percent rate be lowered to 5 percent. Furthermore, section 23 (r) of the Internal Revenue Code, should be amended so that only the first 2½ percent of dividends paid to stockholders and depositors of cooperative and mutual banking corporations is deductible from gross income.

SEC. 101 (4) of the Internal Revenue Code must be amended so that it no longer grants tax exemption to State-chartered credit unions. The applicable provisions of section 18 of the Federal Credit Union Act, section 5 (h) of the Federal Farm Loan Act and section 63 of the Farm Credit Act which extend complete freedom from Federal income taxes to Federal-chartered credit unions, Federal-chartered savings and loan associations, national farm loan associations, and production credit associations must be repealed. After that has been done, cooperative financial institutions will join with the private banks with whom they compete in bearing their share of the tax burden.

The job of correcting the present inequitable situation will take courage because the representatives of the institutions enjoying a tax-favored status may be counted upon to fight against tax justice with all the powers at their command. They will speak about tax equality legislation as penalizing the little people who have put their meager savings in a mutual institution in order to secure some modicum of security against economic disaster. They will seek to divert your attention from the fact that the little people have also deposited their savings in the commercial banks and that present tax favoritism will enable the tax-favored savings and loan and mutual banking systems to take over all the savings field and threaten the taxpaying banks with destruction.

The proponents of the present unfair tax system will make a bitter fight. Make no mistake about it. As stated by Senator George during the 1951 Senate debate on the subject (Sept. 24, 1951, Congressional Record, p. 12197):

"With what tenacity the special-privilege boys who have grown fat off of this country hold onto those special privileges."

Now, when the whole Internal Revenue Code is being revised to remove inequities, is an excellent time to take care of the glaring tax inequity that is injuring the country's private banking system. Fair taxation will not hurt the cooperative and mutual banking system, but on the contrary will only keep them from hurting the taxpaying banks. It will merely restore fairness to our tax laws, fair competition to our banks, and at the same time raise some of the

additional revenues that our country so badly needs to pay the expenses of the cold war.

A. J. FARFEL & Co.,
Houston 2, Tex., April 22, 1954.

In re H. R. 8300, the proposed Internal Revenue Code of 1954.

ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MADAM: Section 6654 of the proposed code deals with additions to the tax for failure by individuals to pay estimated income tax. Subsection (d) sets out certain exceptions. We wish to point out a situation which we feel should be covered in this section of the proposed code.

We have found during our years of practicing public accounting that some individual taxpayers' business operations are so extensive that it is difficult to examine their records and complete the tax returns (forms 1040) within the required time for filing. Even with the proposed addition of 30 days, it would still be difficult.

Such an individual taxpayer would not have available the necessary information about the prior year's income and deductions on which to base his current year's declaration of estimated tax to take advantage with certainty of the relief provided in subsection (d) of section 6654 of the proposed code.

The Commissioner's policy with respect to granting extensions of time for filing the income-tax returns has been a great help with respect to income-tax returns, but the same policy does not apply to declarations of estimated tax.

We would like to see some provision made in the code to the effect that the granting of an extension of time for filing individual taxpayer's income-tax return would automatically extend the time for filing his original declaration of estimated tax provided he filed a tentative declaration of estimated tax and paid interest on any excess between the tentative tax payment and the payment with the final declaration of estimated tax. Thus, an individual taxpayer who obtained an extension of time for filing his income-tax return for 1954 would still be able to base his 1955 declaration of estimated tax on the 1954 income and deductions by first filing a tentative declaration of estimated tax and later filing the final declaration of estimated tax when the 1954 income-tax return had been completed.

Respectfully submitted.

A. J. FARFEL & Co.
By F. W. CONRAD.

STATEMENT TO THE SENATE FINANCE COMMITTEE SUBMITTED BY THOMAS B. MEEK, CHAIRMAN, TAX COMMITTEE, NATIONAL ASSOCIATION OF INVESTORS' BROKERS, APRIL 20, 1954

The National Association of Investors' Brokers is convinced that the Treasury would gain more revenues, and more equity capital would be provided for plants and jobs, if the Congress will reduce the capital gains rate of tax and length of holding period.

Our conviction is based on actual experience, not theory. Our association is representative of securities firm employees who have been servicing hundreds of thousands of accounts over a long period of years. We have observed how the tax laws affect investors and prospective investors, in other words, what they actually do with their money. We have urged revision of these sections of the tax law because we have found them the greatest handicap to judicious investment.

Why do we feel revenues would be increased by reducing this tax and shortening the holding period?

First. Countless transactions never take place. Either a short term profit is missed, because the investor wishes to hold his security to get the tax advantage after 6 months, or, if he has a sizeable long-term profit he regards it as part of his capital assets and will not pay the present rate of tax on the profit. Our analysis of transactions in 1953 indicates that the Government would have collected $200 million additional if the tax had been 12½ percent and the holding period 3 months. We estimate revenues from capital gains in 1953 to be lower than in 1952.

Second. There are large amounts of capital that will not be available for equities until there are changes made in the capital gains provisions. The writer knows of several millions of dollars among his own clients that are locked up for this reason. This can be multiplied many times.

The Members of Congress are properly concerned about the state of business in this country and are well aware that two of the chief bulwarks to our economy, over the short term, are: Government expenditures for defense, and business expenditures for expansion and rehabilitation. How are these private expenditures for capital goods to be maintained? It is well known that a large proportion of the vast sums spent since the war have come out of retained earnings and borrowings. Obviously this trend is unhealthy and cannot be maintained. The only answer, therefore, is increased financing through equities, and that calls for vigorous and healthy securities markets. That can be achieved by permitting capital to flow more freely. As we have said before, the capital-gains tax deters proper reinvestment and discourages new money from buying equities.

It has been assumed in some quarters that speculation would be stimulated by reducing the capital-gains tax and holding period. Actually these provisions have served at present and in the past to contribute to the speculative urge. The effect of these restrictions on taking profits has been to limit the supply of stocks when the market is going up and to increase the supply when the market is going down. Thus, price swings are accentuated in both directions. This is one of the factors in the sharp rise in certain stocks in the market this year. Early in 1946 our association warned that the 100 percent margins and the capital-gains tax prevented many holders from selling, thereby helping accelerate the rise. We also warned of the thin markets that would develop when the trend was reversed, because there would be no buying cushion furnished by those who had taken profits.

It is the basic function of the securities business to produce capital, just as it is of the oil and mining industries to produce oil and metals from the ground. It is an anomaly that the securities industry suffers many restrictions on capital formation, whereas many other extractive industries have been granted tax incentives. Our members have, during the past 20 years, seen a steady deterioration in the supply of equity capital and I venture to predict that if the tax laws are not changed soon, there will come a time when the Government will be forced to offer extra inducements to capital to sustain domestic enterprise, just as inducements are being offered now to encourage investment abroad.

With proper encouragement there is plenty of capital in this country ready and willing to engage in constructive enterprise. We have had confirmation of this in the action of the securities markets this year. The proposal to grant minor tax credits on dividend income has stimulated a large amount of new investment. To cite 1 small example, the writer received an order to buy 200 shares of American Telephone from a man who had heretofore been concentrating his investments in tax-exempt bonds. There are many instances of this. If this tax credit is not retrained in the final tax bill there will undoubtedly be some selling by disappointed holders.

The tremendous expansion taking place in Canada has been financed largely through equities. One of the principal reasons is that Canada gives favorable treatment to those receiving dividends and there is no capital-gains tax.

In view of the many advantages to be gained by modifying the capital-gains tax and holding period, it is difficult to understand why there is such great reluctance to make these changes. The obvious conclusion is that there are political implications in doing anything to help capital. Perhaps if the name were changed to "restrictive enterprise tax" there would be a better chance of modifying it. It is ironic that such an attitude exists in the leading capitalistic country in the world. Actually, the capital-gains tax does not reach the rich, except in small measure, for they either hold their investments or are in tax-exempts or cash. The capital-gains tax and dividend tax hurt the little fellow as well as the big ones. There are 6,500,000 stockholders of public corporations in this country and only a small percent would be considered wealthy. Seventy-four percent of those reporting capital gains and 78 percent of those reporting dividend income, had incomes of less than $10,000 in 1950. It is our belief that one way to insure that the rich pay more capital-gains taxes would be to cut the rate in half.

Our further views and specific examples of the effects of capital-gains tax are given in the accompanying leaflet.

We sincerely appreciate your consideration and express the hope that your committee recommend to the Congress: Reduction of the rate of tax to 12½ percent, shortening the holding period to 3 months, and retention of tax credits on dividends.

NEW YORK 17, N. Y., *April 22, 1954.*

The Honorable EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: The Walworth Co., and its employees covered by the retirement plan of the company, would like to express to you their concern over the provisions of section 505 of the proposed Internal Revenue Code which would limit employees' trusts investments (*a*) in real estate to 5 percent of the trust assets in respect to any 1 investment, and (*b*) in securities of any 1 issuer, other than those specifically authorized, to 5 percent of the trust assets and 10 percent of the voting power of the issuer.

The retirement plan of the company is qualified under existing section 165 (a), and is a contributory, self-administered, trusteed type of employees' pension plan. It was established in 1941 and covers all qualified salaried employees of the company of whom there are currently some 700 employees participating. The trust agreement between the company and the trustee authorizes the company to make its contributions to the trust in kind in warehouse properties (real estate) of the company, and authorizes the trustee to lease such properties back to the company. The total value of such properties held by the trust at any time is limited to 25 percent of the value of the other assets of the trust. The trust agreement forbids the trustee to invest in any securities of the company or its subsidiaries. The trust's assets are presently invested as follows:

	Percent
Government bonds	27.82
Other bonds	32.04
Preferred stocks	6.89
Common stocks	33.25

Approximately one-third of the 33.25 percent invested in common stocks is represented by all of the capital stock issued by a 101 (14) corporation organized for the purpose of holding title to real estate and paying the income therefrom to the trust. It was necessary to organize the 101 (14) corporation, due to the problem (which many employers and trustees have experienced) that the trustee, a trust company of New York, was not admitted to do business or hold title to real estate in the State of the situs of the real estate.

Heretofore the company has conveyed approximately $432,000 in warehouse property in kind, the conveyance having been made to the 101 (14) corporation, and has leased it back in accordance with the terms of the trust agreement and pursuant to the approval of the Treasury Department. The return to the trust is equivalent to the return normally received by insurance companies and other investors in sale and leaseback arrangements, the same being slightly higher than the average return to the trust on its other investments.

In order to meet its contributions to the trust and, at the same time, conserve its cash for employment in its manufacturing business, the company had intended making its contribution to the trust for the year 1954 in the form of warehouse property. However, the limitations of proposed section 505, if they should become law, may require the company to abandon the proposed transaction for the following reasons:

1. The value of a warehouse property intended to be contributed exceeds 5 percent of the assets of the trust While the conveyance was intended to be made to the 101 (14) corporation, it is conceivable that the Revenue Service may rule that the conveyance to the 101 (14) corporation, all of the capital stock of which is held by the trust, would constitute in reality an investment by the trust in real estate which would exceed the 5-percent limitation in respect of any one investment and thus deny the exemption.

2. If, due to unforeseen problems, the presently existing corporation holding title to warehouse property heretofore contributed could not take title in the State of the situs of the warehouse property intended to be contributed, and the trustee could not take title, it would not be possible to form another corporation for that purpose for the reason that all of its capital stock, of necessity, must be held by the trustee and (since the investment would have been made subsequent to March 1, 1954) such would exceed the 5-percent and 10-percent limitations on the securities and voting power of any one issuer.

Obviously, it is important, if private pensions are to be encouraged and not discouraged, that the trusts earn a fair return on their investments, and they should not be deprived of investments in real estate offering good return and

adequate security. Certainly this right should not be denied to the extent that prudent diversification would advise.

With respect to (1) above, it would seem that the restriction would discriminate in favor of the larger trusts. Few of the smaller trusts would be able to locate a parcel of real estate suitable for trust investment which could be obtained within the 5-percent limitation, whereas the larger trusts most likely would be able to find many. This limitation would be particularly harsh on the small business which, except for the limitation, may be able to make its contribution during a lean year in the form of a parcel of its real estate. It would also seem to discriminate among businesses of various kinds: for example, a retail business with many small stores could contribute one or more of such locations, but a business of equal size with only a few locations may find that no piece of its real estate suitable for trust investment could be contributed within the 5 percent limitation; also, the limitation would not realize the announced objective of diversification due to the fact that the trust, under the present proposal, could invest 100 percent of its funds in real estate so long as no single parcel exceeded 5 percent of the trust assets.

With respect to (2) above, many trustees find that they are unable to hold real estate in States other than their domicile; thus, they usually form a corporation to hold title, receive the rents, and pay the same over to the trustees. Since the trustee in nearly every case would own all of the stock of such corporation, the limitation of 5 percent of the securities and 10 percent of the voting power of such corporation would eliminate the availability of this convenient means of overcoming this legal barrier to interstate business; also, this limitation is quite inconsistent with the provision in the proposed section 505 which could specifically authorize unlimited investment opportunities in the securities of the employer creating the trust.

We fail to recognize the desirability of placing any limitation on investments in real estate except for the purpose of assuring a prudent diversification of the trust funds, and it seems that a limitation of 5 percent with respect to a single parcel of real estate does not accomplish that purpose; also, for the legal problems mentioned, it is necessary that trusts, if they are to be enabled to make any investments in real estate, they should be able to do so through corporations in which the trusts own all of the capital stock or other securities issued by such corporations.

Accordingly it is recommended that the limitations referred to be changed to provide a limitation, if a limitation is deemed necessary, of not less than 25 percent wtih respect to a single parcel of real estate. With respect to corporations organized for the sole purpose of holding real estate and paying the rents to the trust, it is recommended that the trust be permitted to hold all of such corporation's securities.

Sincerely yours,

F. W. BELZ, *Executive Vice President.*

SIMPSON LOGGING CO.,
Seattle, April 22, 1954.

The Honorable EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: Simpson Logging Co. strongly protests certain features of H. R. 8300 and respectfully urges that the Senate Committee on Finance amend the bill to retain the present provisions of section 117 (k) of the present Internal Revenue Code as it applies to timber.

The undesirable features of H. R. 8300 with respect to timber are found in sections 631 and 272. These features of H. R. 8300 would defeat the major purpose of the proposed comprehensive revision of the revenue laws (as stated by the Ways and Means Committee), namely, "to remove inequities * * * to end harassment of the taxpayer * * * to reduce tax barriers to future expansion of production and employment * * * and to create an environment in which normal incentives can operate to maintain normal economic growth" (H. Rept. 1337, p. 1).

Section 631 (a), when read with section 272 (a), would require that administrative and other expenses in connection with the holding and measurement of timber, incurred in the taxable year in which the timber is cut, must be added to the adjusted depletion basis of such timber for the purpose of computing capital gains. This is a discrimination against timber owners and operators. This

would be a new requirement which in effect would deny deduction from ordinary income as is now the case. Other taxpayers having capital gains are entitled to deduct taxes, interest, and other appropriate expenses from ordinary income; for example, sales of stocks and bonds, sales of mortgage property, sales of property used in the trade or business and the outright sale of timber as a capital asset. In all of these sales such expenses such as safe deposit box rentals, State stamp taxes, statistical services, interest, property taxes, insurance, fire protection, etc., are deductible from ordinary income and not required to be treated as reductions of the capital gain.

The requirement that certain expenses such as property taxes, forest fire control, etc., must be allocated in part to the timber cut during the year does not appear to be sound and will present serious practical problems in making the allocations.

While it may be true that there are taxpayers with income from timber who have no ordinary income from which to deduct these expenses, it does not appear reasonable that the great majority of timber operators who do have such ordinary income should be denied the right to deduct these ordinary expenses from such ordinary income.

The Senate Committee on Finance is respectfully urged to amend section 631 of H. R. 8300 as passed by the House so as to retain the language of section 117 (k) of the present code insofar as timber is concerned, and strike out the reference to timber in section 272.

Yours very truly,

SIMPSON LOGGING CO.
A. R. GREEN, *Comptroller.*

SAN FRANCISCO, *April 21, 1954.*

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

DEAR SENATOR MILLIKIN: The undersigned had an opportunity recently to study the tax revision bill, H. R. 8300, entitled "Internal Revenue Code of 1954" as passed by the House. This letter is directed primarily to section 1235 entitled, "Sale or Exchange of Patents by the Inventor."

May I respectfully submit to you that while this section is purportedly, and no doubt with the best intentions, for the purpose of encouraging invention and scientific works, in effect it will accomplish exactly the opposite result.

Under existing law, the average inventor is entitled to treat gain from the sale or exchange of a patent or patent application as gain from sale or exchange of capital assets as long as he parts with all interests in a patent or patent application. Under the proposed section, the inventor will not be entitled to the same privilege unless the purchase price is paid within 5 years from the date of such sale. The fact is that in order to obtain anywhere adequate compensation according to the value of an invention, in most cases of worth-while inventions the period of payments must be extended for longer than 5 years. The investor is reluctant to risk large amounts of cash, but will take a chance on long-term payments.

Another object of the bill as it now stands is, of course, that it is limited to the inventor and takes away from an investor or purchaser of a patent its present right to treat a patent or patent application as capital and treat sums made from its sales as capital gain just as in the case of any other income property. This will definitely discourage investors from helping the poor inventor to develop an invention. It will also discriminate against corporate owners of patents who have large capital investments in important developments of inventions.

Obviously, therefore, the professional inventor will not be particularly benefited, but the amateur inventor and the investor will suffer very definite detriment by the proposed section 1235 of the tax revision bill, H. R. 8300.

In view of the above, we respectfully suggest either that section 1235 be completely eliminated, and leave matters in their present status, as bad as it is, or that section 1235 be amended so as to apply to any patent owner and not only to the inventor; and also to eliminate all time limits within which the compensation is to be paid.

The above is based on experience of over 25 years and it is our belief that an investigation will show that proposed section 1235 in its present form is more

of a detriment than help to inventors and investors. This criticism, of course, is offered with due respect to the good intentions of the drafters of that section.

Respectfully yours,

GEORGE B. WHITE.

SOUNDRIVE PUMP CO.,
Los Angeles, Calif., April 20, 1954.

Subject: Patent provisions in the new tax revenue revision bill.

Senator EUGENE D. MILLIKIN, OF COLORADO,
Chairman, Senate Finance Committee,
United States Senate Building, Washington, D. C.

HONORABLE SENATOR: Our oil-potential States are keenly aware of the problem of extracting much of the oil from the earth after wells are drilled. Only about one-fourth of the oil has been obtainable normally, leaving about three-fourths unavailable unless special production (pumping) techniques are employed. The Governors of the several oil-producing States have formed an "oil compact commission" to promote "secondary recovery" procedures to salvage this valuable natural resource which is normally unobtainable. Oil experts know that many bordering States could become economic oil producers if additional recovery techniques could be developed. Included in these techniques would be any pumps having ability to handle difficult liquids, and pumps having a "stimulating" effect on the oil-bearing sands in the earth.

By expending a great amount of time and money our company is making commensurate progress in developing a pump having those desirable characteristics and which could be made available (when species are developed and known) to manufacturers having corresponding facilities, under a licensing arrangement for manufacturing and marketing.

Such a development makes it feasible for the oil companies to enter now-marginal fields with an expansion program. This results in desirable increased taxpaying activity on the part of oil companies, pump manufacturers, and related industries.

Standard Oil Co. of California is expending thousands of dollars testing our pump. Various oil companies also send us purchase orders for pumps. But we have to decline trying to make actual sales now because our pump has not gone through product design development, which is the very expensive final step. After this is done we can easily find corresponding manufacturers who can make, market, and service these pumps in the manner to which the oil industry is accustomed But the financing of this final step requires very large risk capital, which can be attracted to our project only by capital-gains possibilities from the actual patent royalties.

The important point illustrated by our situation is that in this day and age the really new inventions involved "long-haired" scientific principles requiring extensive financing and many years of development and commercialization. These are the big inventions which create new tax money for the Government.

In order to have any meaning, capital-gains treatment of royalty income would have to continue for a length of time at least equal to the lives of the patents. Patent life is 17 years, by law, and is a short time in the light of modern scientific development.

The new tax-revision bill, H. R. 8300, defeats the basic purpose, because capital-gains treatment is limited to only 5 years. This might be all right for a mousetrap invention, but it of no use in the real tax-creating invention field. The inventions of sufficient stature to result in new tax-creating business activity can't be handled by 5-year contracts because market introduction itself takes so long, let alone engineering development.

We realize that your present problem is to obtain revenue, more than to aid some situation, and accordingly we have here pointed out only the actual loss in tax revenue if a realistic change is not made so that patent royalties are capital gains in the actual situation.

The necessary results will accrue only if a new law is enacted to treat patent royalties as capital gains for the full life of the patents.

Thank you for your consideration.

Yours very truly,

SOUNDRIVE PUMP CO.,
A. A. MATHEWSON, *Vice President.*

STATEMENT OF THOMAS J. MCFARLAND BEFORE THE SENATE FINANCE COMMITTEE IN REGARD TO SECTION 175 OF H. R. 8300, APRIL 23, 1954

I am Thomas J. McFarland, general manager of the High Plains Underground Water Conservation District, embracing all and parts of 21 High Plains counties in west Texas, which include a population of almost 300,000 people and 8 million acres of agricultural land. I have come to Washington to present to the committee a modification which is desired in section 175.

Our attention has been called to this section on soil- and water-conservation expenditures. We are certainly in complete agreement with section 175 insofar as it goes; but to carry out the most complete soil- and water-conservation program, it appears one of the most important points might have been overlooked. That point is the immediate encouragement of several practices for the conservation of soil and water, by allowing their deductions from taxable income, under the provisions of this bill. Particularly are these practices necessary in our 17 Western States which embrace almost 65 percent of our Nation's land area but which have less than 22 percent of our Nation's available water supply.

To conserve water in some States, it is almost a necessity that the installation of underground concrete pipelines be laid for the transmission of water from the pumps to the land being irrigated. This is particularly true in areas dependent upon underground water for supply. These pipelines, upon completion, are of solid concrete construction and become a fixed part of the property upon which they are constructed. It is practically impossible to dig up and remove such a line from one location to another.

The lining of ditches in gravity-flow districts has been a tremendous factor in water conservation, weed control, and erosion control. Many colleges and State and Federal agencies have spent considerable time in studies on water losses through open canals and ditches and have arrived at an almost unanimous conclusion that the average loss of water transported by such means is approximately 35 percent of the total gallons pumped. Such losses are caused through seepage and evaporation.

The necessity for concrete and masonry construction in gully control is another practice encouraged by the Department of Agriculture for soil conservation and erosion control. These practices are particularly necessary in the semiarid areas of our Western States where drought often kills our grassed waterways, leaving barren, exposed areas to handle the rainfall that usually occurs in torrential downpours for a few short hours. These periods of precipitation are generally in the early spring or fall months and cause considerable damage by washing gullies and ditches across fields that are out of production during these periods.

The Eastern States are also confronted with similar problems in soil conservation, necessitating the use of masonry or concrete construction to handle excessive amounts of water at times flowing with such force that terraces, grass waterways, etc., are completely destroyed in the attempt to retard or divert runoff. Considerable expense is also incurred in some of these areas in underground drainage systems, usually consisting of tile or concrete pipelines.

Computations have been made on return in tax dollars to the Government from an irrigation farmer using the underground pipeline transmission system against that of an irrigation farmer using an open-ditch system. It has been shown that in a 5-year period the farmer with the pipeline system of operation will pay more tax dollars, even allowing the deduction for the cost of his line by a provision of this bill. The more efficient use of his water will not only cause an increase in his production, cut his fuel bill, but will also be a very major factor in the conservation of a leading resource so necessary to national economy.

There are other data which I am developing which I should like to present to the committee or the staff of the committee when it is ready. It is not ready for insertion at this time with this statement I am preparing for publication in the committee hearings.

I feel certain the encouragement of such conservation measures as the construction of underground pipelines, ditch-lining practices and structures for gully and soil control, by their inclusion in this bill will not only be a wise investment taxwise but also will be a wise investment in the future agricultural economy of our Nation. I respectfully request the committee to more thoroughly explore the details of these measures with the Department of Agriculture

and the Secretary of the Treasury. It is my sincere feeling that the committee, in its wisdom, will see the importance of including these very important practices in section 175 of this bill.

Respectfully submitted

THOMAS J. MCFARLAND.

LUBBOCK, TEX.

SUPPLEMENTARY STATEMENT OF THOMAS J. MCFARLAND, ON APRIL 26, 1954, BEFORE THE SENATE FINANCE COMMITTEE IN REGARD TO SECTION 175 OF H. R. 8300

On April 23, 1954, I was privileged to submit a brief statement before the Senate Finance Committee in regard to section 175 of H. R. 8300, representing the High Plains Underground Water Conservation District of west Texas. At the same time Congressman George Mahon, who represents the 19th Congressional District of Texas, which embraces part of the 21 counties included in the High Plains Underground Water Conservation District, submitted a statement in connection with the same section of the bill. It was suggested at that time that additional data would be presented to the committee or its staff, to be included as a part of and as enlarging upon the brief statement made at that time. This statement is submitted in order to present to you the supplementary data which we desire to make available to the committee for its consideration in final study of the bill.

The High Plains Underground Water Conservation District is an organization formed under the statutes of the State of Texas, providing for the establishment of water-conservation districts, and is composed of all or parts of 21 counties located upon the High Plains of west Texas. Within this conservation district there are approximately 8 million acres of agricultural land and within the area there resides a population of approximately 300,000 people. This statement is submitted on behalf of the High Plains Underground Water Conservation District, but we feel that the problem which we undertake herein to emphasize for the committee's attention is one which is common to water and soil conservation and use practices throughout the entire Nation, particularly in the 17 Western States.

First, we want to commend the Ways and Means Committee for the attention which has already been given to the matter of soil and water conservation expenditures as provided in section 175 of this bill. We strongly urge the Senate Finance Committee to give favorable consideration to the inclusion in this section of the final form of the bill the modification which we propose at this time.

The modification which we feel is needed in order to accomplish an overall equitable adjustment of the tax consequences of soil and water conservation expenditures on our farms throughout the Nation is as follows:

Paragraph (c) (1) of said section 175 should be amended to include in the enumeration of those items defined under "Expenditures paid or incurred by him during the taxable year for the purpose of soil and water conservation and the provisions of soil erosion," the purchase, construction, installation or improvement of structures, appliances, and facilities which are made of masonry, concrete, and title, and being so installed as not to be usable if removed from the land of which it is made a part. Then paragraph (c) (1) (a), the enumeration of excluded items, should be modified to accord with the inclusion of this type of installation in paragraph (c) (1).

For the committee's consideration in analyzing the problem presented by our proposal, we respectfully submit the following:

The problem is one of soil and water conservation. The extent of the need for better improved and more efficient water and soil conservation methods is emphatically illustrated by the following statements from research and technical sources summarizing various studies which have been made in recent years.

In June 1948 the Bureau of Reclamation of the United States Department of the Interior published a bulletin entitled "Lower Cost Canal Linings—A Progress Report on the Development of Lower Cost Linings for Irrigation Canals" in which the statement was made:

"It has been estimated that one-third of all the water diverted from Western streams for irrigation is lost in transit to the farmland, and it is known that in a few individual cases this loss in transit is as great as 60 percent. Of the 14,600 acre-feet of water diverted for use on 36 Bureau of Reclamation projects in 1946, approximately 37 percent was lost in transit. More than half of the

transit loss, or 23 percent of the total water diverted, was attributed to seepage from canals and laterals. The remaining 14 percent was lost through waste."

From Technical Bulletin 38, published by the Colorado Agricultural Experimental Station, Colorado A. & M. College, which bulletin is entitled "Seepage Losses From Irrigation Channels," published in March 1948 the following statements again emphasize the importance of more efficient methods of handling as a conservation measure. Mr. Carl Rohwer and M. O. V. P. Stout who conducted the study, the results of which are presented in this bulletin, stated:

"Nearly 100 million acre-feet of water are diverted annually from streams, reservoirs, and ground water basins to irrigate crops in the arid regions of the West. From one-third to one-half of this amount is lost before it reaches the farmers' fields."

This bulletin also states:

"Of the 125,000 miles of canals and laterals used for irrigation in the 17 Western States, less than 5,000 miles had been lined by 1939, although the census records show that 35 percent of all the water diverted for irrigation was lost before it reached the point of delivery to the farm."

The increasing significance of the problem in our own State of Texas is forcibly brought out by a statement contained in the Texas Agricultural Experiment Station, publication 59, Irrigated Agricultural in Texas, published in September 1950, in which the following statement was made in a digest of that bulletin:

"The expansion of irrigation during the war and postwar years advanced irrigation farming to a significant place in Texas agriculture. During the 9-year period 1940–48, the area under irrigation expanded from 1,045,000 to 2,855,000 acres. In the latter year nearly 30,000 Texas farms were partly or wholly dependent for their production upon water supplies obtained either from surface or underground sources.

"Approximately 10 percent of the State's total acreage of principal crops harvested in 1948 was from irrigated land. What is more significant, crops from irrigated land accounted for nearly 30 percent of the total farm value of all principal crops grown in Texas.

"Most of the expansion in irrigated land resulted from individual developments of ground water resources. These developments account for 1,369,000 acres, almost three-fourths of the 9-year increase, as compared with an increase of 463,000 acres in developments utilizing surface water supplies."

The growth of irrigation in Texas, as indicated by the above statements, is typical of the increased growth and expansion of irrigation throughout the Nation. Until recent years, the conservation of water was considered to be mainly one common to the arid and semiarid States of the West and Southwest. However, we feel that this committee will readily recognize the growing importance of water as one of our national resources which is being seriously depleted throughout the Nation as a whole.

Ephasis has been placed upon the development of large projects which impound the surface waters in great reservoirs, and these have made a definite contribution to our national economy. But the problem of conservation and efficient use of the greater quantities of our water, which contribute the most to our national economy, lie not in the great projects which receive national attention but in the use of water on the individual farms.

Unless we give serious consideration to the efficient use of the water on the individual farms, the great expenditures for large dams and distribution systems will become ineffective, from an agricultural point of view.

The cost of installing water handling facilities on the individual farm is a matter which must of necessity fall upon the man who is actually engaged in the business of farming. This is particularly true in areas where underground waters are utilized and in the more humid regions where available supplies are developed from small streams, lakes, and other surface sources.

The maximum utilization of water resources in the Nation as a whole can best be accomplished from the point where we find ourselves today by making it economically feasible for the individual farmer to put into effect efficient development and use practices.

The studies above referred to indicate the great waste of water from the open-ditch method of distribution to the farm The open ditch is the common method of distribution over the farm itself, and consequently results in similar losses from seepage and waste before being spread over the cropland itself. Much progress has been made toward improvement of the larger distribution systems. but too little progress has been made on the individual farms.

In Agricultural Experiment Station, Utah State Agricultural College, Bulletin 311 (March 1944), Dr. O. W. Israelsen defined water-application efficiency as: "The ratio of the amount of water that is stored by the irrigator in the soil root zone and ultimately consumed (transpired or evaporated or both) to the amount of water delivered at the farm." Reporting upon the results of water-application-efficiency tests in Utah County, representing a 3-year study and 145 tests, and in Salt Lake County, representing 1 year's study and 28 tests, Dr. Israelsen found that in Utah County efficiencies ranged from 24 to 51 percent with an average of 40 percent, and in Salt Lake County from 18 to 58 percent with an average of 35 percent.

Our greatest contribution to water conservation would be the elimination of this great waste by improvement in the methods of distribution and use upon the individual farms. This can be accomplished by encouraging the individuals engaged in the business of farming to install upon the farm where the water is used more modern and up-to-date methods of application. These methods, which are being encouraged by the Department of Agriculture and the various State agricultural colleges, include not only the grading and terracing, contour furrowing, construction of diversion channels and drainage ditches, the control and protection of water courses, outlets, and ponds, as enumerated in the bill as now written, but also the installation of underground concrete pipelines, both for distribution and drainage, the lining of ditches, the installation of concrete check-dams and the use of concrete tile and other masonry in gully control. These modern water- and soil-conservation methods are not only being encouraged by State and Federal agencies, but by many other organizations interested in the agricultural economy and the conservation of soil- and water-resources.

In spite of the research which has been done and effort which has been made by State and Federal agencies, as well as other organizations, the development of these more efficient systems has been slow because of the large initial expenditure which must necessarily be made by the individual farmer. Many farmers who recognize the conservation and economic value of these installations have been unable to provide them in their farming operations because of the large initial expenditure which cannot be deducted as an expense except over a lengthy depreciation period.

The type of installations which we are recommending as a directly deductible expenditure are those which are not removable or resalable and which contribute to water and soil conservation as well as providing a means of distribution, of which the concrete and tile underground pipe, ditch linings, check-dams, and gully-control structures are examples.

If the individual engaged in the business of farming were allowed to deduct the cost of the above-mentioned practices in the same way as those items enumerated as directly deductible in the bill in its present form, the conservation methods which have been so widely recommended by State and Federal agencies and other agricultural organizations would be definitely activated.

The effect of this modification would be fourfold: (1) A greater economic return to the farmer through increased production; (2) correspondingly greater tax return to the Government through increased income taxes; (3) long-range benefits to the Nation as a whole through conservation of water and soil as our most essential natural resources; and (4) an economically feasible means by which the individual farmer may contribute to our conservation program without direct Government participation and controls.

Should the committee desire additional information concerning the proposed modification, we will appreciate the opportunity of appearing at your convenience.

Respectfully submitted,

HIGH PLAINS UNDERGROUND WATER CONSERVATION DISTRICT,
By THOS. J. MCFARLAND, *Manager*.

F. STANLEY WALDORF,
Pittsfield, Mass., April 22, 1954.

SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: The writer respectfully requests your personalized interest in the consideration of a herein proposed change in the wording of the hereinafter-named section of the Internal Revenue Code, incorporating such change in the redrafts now under way under H. R. 8300.

Internal Revenue Code, section 25 (b) (1) (D) reads at present: "An exemption of $600 for each dependent whose gross income * * * is less than $600 * * *, etc."

The writer presents that the word "gross" as therein employed should be changed to read "net" or that a redraft of the wording of that subsection be made effecting it, "An exemption of $600 for each dependent whose income is not subject of a tax * * *."

In support of that recommendation, I offer: In that one having a "gross income" of $600 and/or over is required to make a return even though allowable credits against such gross income renders the income nontaxable, the one reporting has therein, and nonetheless, exhausted his or her credit for $600 (sec. 25 (b) (1) (A)), and regardless of the financial and/or health status of the one so reporting, because the credit has been exhausted as required, dependency credit for another is prohibited, and often painfully, by the employment of the word "gross" instead of "net", aforestated.

It is not believed that is at all the spirit of intent of the present letter of the subsection referred to.

Should the proposed change have been previously considered, and that negative retained, will you be so kind as to permit my reasoning to the contrary as herein given as briefly as seen to be practical? I am totally unable to reconcile the above as appertains to the income of one who is an otherwise qualified dependent of another with the same as applies to those who are not dependents.

The confusion might emanate from a seeming lack of perfectly uniform definition of "gross income" and as applied variously—appreciating the difficulty of effecting it thus uniform. In the instance of one who has a gross receipt from rents (called income from rents—not gross income), is the net result of the computation prescribed for it which is carried to the face of 1040. In the instance of a rental holding, as in a partnership, real or in effect, it is the net result thereof with which each such partner is charged or credited on his or her individual return. Why, then, should the same not be effected true in the instance of one who is an actual dependent of another, even though the gross rental receipts are in some excess of $600 but the net thereof may be far under the $600, and which would be true when such gross income or gross receipts from other than rentals after allowable deductions therefrom resulted in a less than $600 net?

A case to point briefly stated:

P bought a double house in May 1947 paying $10,125 (land additional) Downpayment on total, $12,250, was $6,000. Local bank took mortgage on balance—reduced, by March 1954, principal and interest to $3,636.75.

P was stricken and rendered incapable of any work a few months after purchase. This developed into Parkinson's disease—which is seen as progressive and incurable. Present status in that extreme. J, his wife must remain at home with him, obviously. The medical bills of P and J for 1953 were slightly over $600. The payments on the house and the support of P and J as mother and father fell upon two sons. Their earnings—per W2 and returns—were $2,730.62 and $2,158. Both single and living with supported parents. I might interject that 1953 was the first earnings for the latter, and were good considering his some 80 percent loss of use of right arm in World War II. Receives some benefits—not taxable. Government treatment has restored total loss of use to present perhaps 20 percent.

Rental figures: Residence one-half rent, $744; depreciation, $158.22; repair 1953, none; other, $376.45; net income, $209.33. Residence one-half rent—acquired May 1947; cost, $10,215; depreciation, $868.12; current depreciation (one-half), $158.22.

Credit for dependency disallowed by Boston, notwithstanding exceptions provided, because gross income (gross receipts of rents) was $600.

Title to property P and J as tenants by the entirety. Prentice-Hall Phg. 7198, page 7020, 1954, gives "Massachusetts: all the income from personal property and receipts and profits from real estate is taxable to the husband." But Massachusetts does not require a reporting on rental income—except in the instance of multiple holdings and in which it becomes—a business. Their ruling merely fixes the responsibility upon the husband in any and all individual cases as described. The word "all" does not relate to gross receipts except as they serve to affect the net income—in cases of a business of renting numerous properties.

The first son, whose income is first above reported, has now been drafted into the Armed Forces. The suggested change in wording would effect a proper

and due credit to a taxpayer for such dependency. What we call gross profit for a business is not the gross receipts but these less cost of goods sold; and this is qualified, for a business, as gross income, taxwise, hence the failure to in anywise reconcile.

Respectfully yours,

F. STANLEY WALDORF.

NEW YORK STATE TITLE ASSOCIATION,
New York 6, N. Y., April 21, 1954.

Re H. R. 8300 sections 34 and 246 thereof limiting dividend credits.

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

SIR: This association, representing 14 title-insurance companies in the State of New York, considers the proposed relief from double taxation of dividends as highly desirable. It is felt, however, that sections 34 (c) (1) and 246 (a) (1) of the proposed Internal Revenue Code of 1954 are defective from a technical standpoint and cover corporations not intended to be covered.

Consequently, enclosed herewith for your consideration and for presentation to the Senate Finance Committee is a memorandum suggesting amendments to sections 34 (c) (1) and 246 (a) (1). These are the same amendments proposed by the California Land Title Association.

Sections 34 (c) (1) and 246 (a) (1) as passed by the House of Representatives exclude from the relief dividends paid by an insurance company subject to a tax imposed by subchapter L (sec. 801 and following). This exclusion would apply to title-insurance companies.

The taxable net income of title-insurance companies is substantially the same as that of general business corporations with the exception of a small proportion of gross income (about 4 percent) considered to be unearned premiums. Title insurance is a single-premium type of insurance which remains in force as long as the insured retains the insurable interest. The accounting systems employed by title-insurance companies are very similar to those employed by general business corporations. Also no particular tax benefits derive from being classified as insurance companies.

Since it is clearly the intent of the tax-revision bill to allow the dividends received credit in situations where double taxation exists it is submitted that title-insurance company dividends should be included in the relief provisions.

Respectfully submitted.

ROBERT A. KERSTEN, *President.*

MEMORANDUM RE PROPOSED AMENDMENTS TO SECTION 34 (c) (1) AND 246 (a) (1), H. R. 8300, RELATIVE TO DIVIDENDS PAID ON STOCK OF CALIFORNIA TITLE-INSURANCE COMPANIES

I. PROPOSED AMENDMENTS

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"SEC. 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(c) *No credit allowed for dividends from certain corporations.*—Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

"(a) *Deduction not allowed for dividends from certain corporations.*—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

STATEMENT TO THE COMMITTEE ON FINANCE, UNITED STATES SENATE, APRIL 16, 1954

(Statement by E. C. Stephenson, vice president, the J. L. Hudson Co., Detroit, Mich., representing the National Retail Dry Goods Association, 100 West 31st Street, New York City; the American Retail Federation, 1625 I Street NW., Washington, D. C.; and the Limited Price Variety Chains, 25 West 43d Street, New York, N. Y.)

The National Retail Dry Goods Association, the American Retail Federation, and the Limited Price Variety Chains urge this body to include in section 472 of H. R. 8300 the language contained in H. R. 5295 and H. R. 5296, introduced May 20, 1953, in order to permit the use of the lower of LIFO cost or market for the valuation of inventories for the determination of taxable income.

The compelling need for this provision in the law is evidenced by the character of the many organizations which testified before the House Ways and Means Committee to urge that body to include the provisions of H. R. 5295 and H. R. 5296 in section 472 of H. R. 8300. The organizations which testified appear on page 12 of this statement.

The National Retail Dry Goods Association has a membership of over 7,000 department and specialty stores operating in all 48 States, the District of Columbia, Hawaii, and Alaska. These stores employ many thousands of people and do between $11 and $12 billion in total annual sales. The American Retail Federation is the parent association of the vast number of retail stores and associations shown on page 11 of this report. The Limited Price Variety Chains comprise 8,500 stores operating in all 48 States, the District of Columbia, Alaska, and Hawaii, employ many thousands of people, and do in excess of $2.5 billion in total annual sales.

Retailing has a particular interest in this legislation because of past inequities imposed on the trade by the Treasury Department.

In the Revenue Act of 1939, Congress enacted section 22 (d) (1) of the Internal Revenue Code, providing that all taxpayers could use the last-in, first-out (LIFO) principle for pricing inventories for the purpose of avoiding the inclusion of price rises with taxable earnings.

However, the Treasury Department consistently refused to permit retailers to use this method of inventory valuation. Sometimes rulings were based on the grounds that inventories of retailers lacked homogeneity, as typified by the statemen tof Randolph E. Paul on June 15, 1952, before the Senate Finance Committee. In all cases where retailers used the retail method of inventory valuation, the Commissioner ruled that LIFO was not applicable.

Relying on the many informal adverse rulings made by the Commissioner of Internal Revenue, many retailers who had complied with all the regulations required in order to adopt the LIFO plan and who had actually filed income-tax returns under the plan abandoned their attempt and returned to traditional methods of inventory valuation. Other retailers felt that in view of the Commissioner's rulings, it was futile to attempt to elect the LIFO method of inventory valuation with all of its stabilizing benefits, and therefore made no attempt to exercise their statutory right.

About 30 retailers in the country persisted in their belief the Commissioner was entirely wrong in his position and continued to file income-tax returns based on the LIFO method. Deficiency assessments were consistently made against them by the Internal Revenue Service.

Finally, this group decided to have a test case taken through the courts to determine whether or not the Commissioner had the authority to deny one class of taxpayers a right conferred by the Congress of the United States and, at the same time, permit other classes of taxpayers to exercise that same right.

Hutzler Bros. Co., a very large department store located in Baltimore, Md., agreed to become the litigant. The American Retail Federation spearheaded the conduct of the case through the courts. On January 14, 1947, Judge Opper of the Tax Court of the United States decided that the LIFO theory could be properly adapted to inventories maintained in dollars under the retail inventory method. It took from early in 1943 until January 14, 1947, to secure the right to use a method granted by the Congress of the United States in 1939, at a cost to the taxpayer for legal fees and creating indices acceptable to the Commisioner, of about $150,000. It required still another year from January 14, 1947, to secure regulations governing the use of the LIFO principle.

In spite of Judge Opper's decision, as recently as 1952, the association was in controversy with the Treasury Department because it was denying the right to use the LIFO principle to specialty stores. The Treasury claimed that the department store indices did not apply to identical merchandise carried by specialty stores, just because the specialty stores do not carry furniture, home furnishings, carpeting, and other categories of merchandise traditionally carried by department stores. After months of dispute the issue—and there should never have been one—was resolved in favor of the specialty stores. From 1948 through 1951, the National Retail Dry Goods Association and the American Retail Federation carried on a vigorous campaign to secure the retroactive right to 1941 for retailers to use the LIFO principle, file claims for refund and recover many millions of dollars of taxes improperly collected because of Treasury Department rulings which directly overruled the wishes of Congress as expressed in its 1939 legislation. The fight for retroactivity was lost because of the Treasury's claim that the impact on the Federal revenue would be disastrous, although computations made by our associations and others, indicated that a realistic estimate of aggregate refunds would have been somewhere between $120 million and $500 million as contrasted with the Treasury's estimate of over $2 billion.

The LIFO method of inventory valuation has one simple but extremely important effect on business earnings. It reduces them in periods of price increases and increases them in periods of price declines and produces greater tax revenues when they are most needed.

Had all taxpayers been allowed by the Bureau of Internal Revenue to adopt this pricing principle as originally intended in the 1939 act, much of the extensive price inflation now contained in current inventory values, would not exist. The United States Department of Commerce Survey of Current Business, issue of May 1953, on page 22, contains the following statement: "Inventory growth has characterized the postwar period, but in most recent years it has been overstated by the reported change in book value. In 1947, for instance, only 1.4 billion of the book value change of 8.7 billion represented physical change at current prices. The additional 7.3 billion increase in book value represented the effect of rising prices on inventory valuation." A very substantial portion of those $7.3 billion was paid out in income taxes to the Federal Government with a consequent serious impairment of the working capital of business concerns.

Had 1947 spelled the end of the price rise, the overstatement of inventory values would have been serious enough. Prices continued to rise in 1948. In 1949 they started to drop and then come Korea in 1950 with its sharply spiraling price rises, brought in part by actual shortages and in part by fear of the population that the conditions of World War II would repeat, and hard goods, as well as shirts, hosiery, sheets, pillowcases, and other types of merchandise would be unobtainable again.

In January of 1950, the J. L. Hudson Co., my employer, again steriously considered adopting LIFO. Prices had been declining for several months. The time seemed propitious to go on the plan. Before proceeding, however, we consulted our economist, asking him to project the price level on the basis of the 10 classifications of the Bureau of Labor Statistics LIFO index for each year to and including January 1960. His projection frightened us. The present LIFO rules require that once having adopted LIFO, the starting inventory value is frozen permanently into the balance sheet, regardless of whether prices are rising or falling. We projected tax costs for each year inclusive of 1959, ending in January 1960. While the projection showed a very large protection of working capital for the year 1949, ending January 31, 1950, it showed that by January of 1955, the fall in the price level not only would dissipate the protection received for our 1949 year, but also consume in excess of an additional $200,000 because of the effect of freezing the starting value of a LIFO-computed inventory into all future calculations. This loss could never have been recovered under the present rigid LIFO rules We did not adopt LIFO. In spite of the fact we are convinced it is the proper basis for inventory valuation, we decided to wait for a more propitious point in the price cycle.

With a court decision favorable to retailers in January of 1947, and with regulations unavailable until early 1948, prudent retailers did not dare adopt LIFO and forego the right to write down these same inventories they would have been forced to fix into all future values at the high cost values prevailing in 1947 and 1948, and which are still higher today. Accordingly price inflation has continued to accumulate in business inventories, creating large segments of unrealized profits upon which dividends, wage increases, income, and excess

profits taxes have been and are being paid. The inventories at inflated values constitute an overhanging threat of loss against future years' profits in the event of future price deflation. All the signs seem to point toward a slow but steady deflation in the years ahead.

Under the proposed amendment contained in H. R. 5295 and H. R. 5296, to section 22 (d) (1) of the Internal Revenue Code, taxpayers can make permanent reductions in inventories to market value to the extent that prices decline below the starting cost computed under the LIFO method of pricing. This will permit companies which dared not adopt LIFO due to the narrow Bureau regulations in effect for the past several years, an opportunity to adopt LIFO without further delay, and without surrendering the right to write down today's high beginning cost values, if prices decline.

If this should seem like too great an advantage is being given the taxpayer, it must be remembered that companies which adopt LIFO under the provisions of H. R. 5295 and H. R. 5296, are in the identical position if prices decline, that they would be if they remained on the old first in, first out (FIFO) basis, until such time as prices reached a lower level more acceptable for the purposes of a shift to LIFO. Valuing inventories at the lower of cost or market is an approved method by the Department of Internal Revenue if the taxpayer is on the FIFO basis of valuing inventories. This amendment to the code only gives the LIFO-basis taxpayer the same privileges enjoyed by the FIFO-basis taxpayer.

It must be recognized also, that when prices increase over present levels, income that is reduced or rather deferred through the use of LIFO, will become additional income subject to taxes when prices recede. Thus no taxable revenues are permanently lost, they are shifted to the year when they are actually realized and available for taxation.

There is a well-recognized accounting principle that all foreseeable costs and losses should be provided for, and profits should not be recognized until they are realized by actual sale. Many companies have refrained from adopting LIFO under present conditions because the administration of section 22 (d) (1), due to the opposition to its use for so many years by the Bureau of Internal Revenue, would force them to abandon sound and accepted business and accounting principles of long standing. Long experience has taught business people that costs and losses must be provided for when they appear because it has been demonstrated forcibly over the years that once a loss seems imminent, it actually happens much more often than not. The principle that income should not be recognized until realized is based on the knowledge that until an item is actually sold, there is no assurance that it might not be sold at a loss.

Cost of market, whichever is lower, as I have previously stated, is recognized by the Bureau of Internal Revenue as a proper procedure for tax purposes in connection with other methods of inventory valuation. H. R. 5295 and H. R. 5296, in amending section 22 (d) (1) of the code, grants the same privilege to LIFO basis taxpayers. This not only removes the inequitable discrimination against the LIFO basis of the present provisions of the code, but it will also accomplish three additional important corrections:

1. It will alleviate the inequitable treatment retailing received because of the adamant opposition of the Bureau of Internal Revenue from 1940 till 1948 to the right to use LIFO. It was only after Judge Opper in the Hutzler Bros. case ruled that Congress was right, that all taxpayers have been granted the privilege to use the LIFO basis of inventory valuation, that the Bureau of Internal Revenue relented in its attitude.

It will not restore the tens of millions of dollars of taxes improperly paid since 1940, because of the Bureau's position. It will protect those retailers who adopt LIFO after this revision to the code, from the hazards of price decline after they are on the LIFO method, so that at least to the degree of price decline in the period ahead, they will have restored to their base for LIFO inventory valuation, a price level that approaches that of 1939 when Congress granted the right to use LIFO to all taxpayers.

2. It will permit taxpayers to adopt LIFO at once. They will not be exposed to the hazard of trying to outguess the fluctuations of price movements. As has been pointed out earlier in this statement, under the present provisions of section 22 (d) (1) of the code, the taxpayer can remain on the FIFO basis of valuing inventories at the lower of cost or market until such time that he believes a price level has been reached propitious for the switch to LIFO.

H. R. 5295 and H. R. 5296 remove the necessity for such attempts to foretell the future by taxpayers.

3. It puts the reporting of business profits for tax purposes on the same economically correct basis as that used by the Department of Commerce in its national income accounting.

In the National Income Supplement to the Survey of Current Business, 1951 edition, page 39, and again on page 21 of the May 1953 issue of the Survey of Current Business is stated: "The basic principle of the LIFO method, the charging of current costs to current revenues, is essentially the same as that embodied in national income concepts."

To summarize, the National Retail Dry Goods Association and the American Retail Federation urge that the provisions of H. R. 5295 and H. R. 5296 be enacted into law for the following reasons:

1. By so doing, to some measure, the serious inequity imposed on retailers because of the adamant opposition of the Bureau of Internal Revenue to the adoption of LIFO by retailers, will be corrected. During the period of 10 years subsequent to 1939, prices have doubled, and have continued to rise since 1948.

2. Giving all taxpayers who adopt LIFO, the right to write down to the current cost or market, will give them no greater deductions than they will have if they remain on FIFO, which permits valuation at the lower of cost or market, awaiting a lower seemingly desirable price level—then shift to LIFO.

3. Encouraging the adoption of LIFO by permitting all taxpayers to use the lower of LIFO or market will prevent further paper profits if prices go up and thus prevent additional paper losses if and when prices recede from such higher levels.

This will have the further advantage, during periods of rising prices, of preparing more realistic earnings statements, devoid of paper profits, that will make for better understanding between management and labor, since wage demands follow closely reported company profits.

4. Over a complete price cycle, the same amount of business profits will be available for taxation. Profits are merely shifted to the year within the cycle in which they are realized. On page 20, May 1953 issue of Survey of Current Business, the Department of Commerce states: "Over a complete price cycle total profits before taxes will tend to be similar for any one firm, under either (LIFO or FIFO) method."

5. For shorter periods of less than a complete price cycle, the effect on taxable revenue will be to level out profits as between years, a definite benefit to both the business economy because of the protection to working capital since taxes will not be paid out of paper profits; and to the Treasury because of greater stability of earnings subject to taxation as between years.

Quoting from the Survey of Current Business, page 20, May 1953 issue: "Another reason for the spread of LIFO is the greater stability of LIFO profits relative to FIFO profits over an extended period. LIFO profits are lower in times of rising prices when profits are typically high. Conversely, reported profits are greater (or losses smaller) under LIFO than under FIFO in times of falling prices when profits are typically low. To many businessmen, the smoother, more stable picture of earnings provided by LIFO, is one of the more attractive features of the method." This quotation emphasizes the recognition of the Department of Commerce of the desirability of the LIFO method of inventory valuation for all purposes.

6. If all business concerns usel LIFO in their published earnings statements, there would be more realistic long-term appraisals of business earnings. This would tend to have a moderating influence on cyclical swings in business activity, at least to the extent that such swings are due to price rises resulting from a national urge to build up inventories, or price declines, because of business fears of too heavy inventories and a desire to liquidate them.

7. Assuming that H. R. 5295 and H. R. 5296 are enacted into law, it is extremely doubtful that all paxpayers would at one and the same time adopt the LIFO principle of valuation unless a serious upward spiral in prices should again manifest itself. If prices continue to recede as they seem to be doing now, there would be no need for haste in adopting the method. The effect on business profits and tax revenues would be the same under either (LIFO-FIFO) method, since both methods would use the lower of cost or market for valuing inventories. The shift from FIFO to LIFO would be a gradual one over a period of years in my opinion, and the effect on the Federal revenue, slight.

8. Finally, by permitting all taxpayers to adopt the lower of LIFO cost or market, price inflation will gradually be removed from all business inventories, business earnings will be actually realized earnings, available for wage increases,

dividend payments, new capital investment so necessary to the continued growth of our economy, and tax payments.

AMERICAN RETAIL FEDERATION, 1625 EYE STREET NW., WASHINGTON 6, D. C.

National associations

American National Retail Jewelers Association
American Retail Coal Association
Association of Credit Apparel Stores, Inc.
Institute of Distribution, Inc.
Limited Price Variety Stores Associates, Inc.
Mail Order Association of America
National Association of Chain Drug Stores
National Association of Credit Jewelers
National Association of Food Chains
National Association of Music Merchants, Inc.
National Association of Retail Clothiers & Furnishers
National Association of Shoe Chain Stores
National Foundation for Consumer Credit
National Luggage Dealers Association
National Retail Dry Goods Association
National Retail Farm Equipment Association
National Retail Furniture Association
National Retail Hardware Association
National Retail Tea and Coffee Merchants Association
National Shoe Retailers Association
National Stationery & Office Equipment Association
Retail Paint & Wallpaper Distributors of America, Inc.

State associations

California Retailers Association
Colorado Retailers Association
Delaware Retailers Council
Florida State Retailers Association
Georgia Mercantile Association
Idaho Council of Retailers
Illinois Federation of Retail Associations
Associated Retailers of Indiana
Associated Retailers of Iowa, Inc.
Kentucky Merchants Association, Inc.
Louisiana Retailers Association
Maine Merchants Association, Inc.
Maryland Council of Retail Merchants, Inc.
Massachusetts Council of Retail Merchants
Michigan Retailers Association
Missouri Retailers Association
Nevada Retail Merchants Association
Retail Merchants Association of New Jersey
New York State Council of Retail Merchants, Inc.
North Carolina Merchants Association, Inc.
Ohio State Council of Retail Merchants
Oklahoma Retail Merchants Association
Oregon State Retailers' Council
Pennsylvania Retailers Association
Rhode Island Retail Association
Retail Merchants Association of South Dakota
Retail Merchants Association of Tennessee
Council of Texas Retailers Associations
Utah Council of Retailers
Virginia Retail Merchants Association, Inc.
Associated Retailers of Washington
West Virginia Retailers Association, Inc.

ORGANIZATIONS WHICH TESTIFIED BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ADVOCATING LEGISLATION (H. R. 5295 AND H. R. 5296) TO PERMIT THE LOWER OF COST OR MARKET AS THE BASIS FOR INVENTORY LEGISLATION

Wallace Jensen, chairman, subcommittee on Federal taxation, American Institute of Accountants.

Robert W. Wolcott, chairman of the board, Lukens Steel Co., Coatsville, Pa., for National Association of Manufacturers.

Maurice E. Peloubet, of Pogson, Peloubet & Co., New York City, certified public accountants.

H. T. McAnly, general partner, Ernst & Ernst, Cleveland, Ohio, certified public accountants.

E. C. Stephenson, vice president, the J. L. Hudson Co., Detroit, Mich., appearing for the National Retail Dry Goods Association and the American Retail Federation.

K. F. Briden, manager, tax department, Archer Daniels, Midland Co., Minneapolis, Minn.

John V. Van Pelt III, representing the Kendall Co., Walpole, Mass.

Paul H. Nystrom, president. Limited Price Variety Stores Association, Inc., New York City.

Thomas Jefferson Miley, Commerce and Industry Association of New York, Inc.

C. W. Kable, Jr., secretary and assistant treasurer, Deering, Milliken & Co., Inc., New York, N. Y.

Henry B. Fernald, chairman tax committee, American Mining Congress, Washington, D. C.

Lovell H. Parker, chairman special tax committee, National Coal Association.

C. A. Pettyjohn, vice president, American LaFrance Foamite, Corp., Elmira, N. Y.

Ellsworth C. Alvord, attorney, Washington, D. C.

A. T. Bullock, treasurer, National Biscuit Co., New York.

National Association of Wool Manufacturers.

Paul D. Seghers, chairman, Federal tax legislative committee of the Federal Tax Forum, New York City.

Addison B. Clohosey, Esq., for Research Institute of America, New York, N. Y.

Del R. Paige, chairman taxation committee, Georgia State Chamber of Commerce, Atlanta, Ga.

Pennsylvania State Chamber of Commerce.

BEVER, DYE, MUSTARD & BELIN,
Wichita 2, Kans., April 22, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR: This letter is written as counsel for the National Cooperative Refinery Association of McPherson, Kans., to register objection to certain provisions of the proposed Revenue Code of 1954. The taxpayer is a farmers' cooperative association owned by five large cooperative associations to operate a modern oil refinery to supply gasoline and other refined products to farmer patrons of the member cooperatives throughout many States. The taxpayer is not exempt from taxation and as a taxable cooperative pays income tax on amounts used to pay dividends on its stock, and on any profit derived from nonmember business. Ninety percent or more of taxpayer's business is done with member patrons and only about 10 percent or less with nonmembers.

The taxpayer corporation has outstanding certain debenture notes having a definite maturity date. Interest at the rate of 4 percent per annum is absolutely payable on such notes. However, the debentures are subordinated to the claims of other creditors. These debenture notes are owned by the five-member cooperatives, and were subscribed for by the member cooperatives in the ratio of patronage, to provide funds for the expansion and modernization of the refinery and for working capital of the taxpayer. The bulk of the debenture notes were issued for cash, but a portion of such debentures were issued for and accepted in direct payment of patronage rebates accrued and owing to the member cooperatives. Certain of the member cooperatives have pledged these debenture notes with the Federal Bank for Cooperatives or with other banks as security for loans to such member cooperatives.

Under the present law, the interest on these notes is deductible by the taxpayer as interest expense. Actually only 10 percent or less of the interest paid accomplishes any reduction in taxable income since only a small portion of taxpayer's business is with nonmembers, and such interest-bearing debenture notes were obviously not issued to secure any tax advantage, since the interest paid results is only a negligible reduction in taxable income.

The taxpayer understands that under the provisions of section 275, and section 312 (b), (c), and (d) of the proposed Revenue Code of 1954, these debenture notes representing indebtedness would be classified as "nonparticipating stock," with the result that the interest paid on such notes would no longer be a deductible expense and the amounts paid as "interest" would probably be classified as dividends, and the amount used to pay such interest now called dividends would constitute taxable income in full to this taxpayer.

The taxpayer believes it is unfair and inequitable in the extreme to suddenly have a yearly item of interest expense which does the taxpayer only negligible good as a deduction, suddenly transformed into an item of income taxable in full to the taxpayer. This is especially inequitable in view of the fact the debentures were subscribed for in the ratio of patronage, and if, in the judgment of Congress, the interest should not be allowed as interest expense, its real nature

is more in the nature of a distribution of patronage rebates than in the nature of a dividend. It would really make little difference to the member cooperatives, whether they receive yearly amounts as interest or receive additional amounts as patronage rebates, but the taxpayer, having issued such notes in reliance on present law, may find itself entrapped by the proposed new law, and it may be impossible to make any change in the form or provisions of the notes outstanding, since many of them are pledged as security.

The taxpayer believes that, if such provisions are enacted, it is unfair and inequitable to taxpayers in general to make such provisions applicable to already outstanding securities. If such provisions are enacted, the taxpayer believes such provisions should at least be limited in effect to securities issued after date of enactment of the act.

In any event, the taxpayer believes that where interest on debentures is paid by a cooperative association to its member patrons that some option or election should be granted to treat such interest expense as an additional patronage rebate distribution rather than as a dividend.

The second objection of the taxpayer to the proposed new code is probably more a desire to secure a clarification of wording rather than a real objection by this particular taxpayer to the code provision.

The proposed code section 309 provides a very severe penalty surtax on all redemption of nonparticipating stock, with certain specifically enumerated exceptions. Since certain debentures issued are classified as nonparticipating stock, the provisions of section 309 would seem to be applicable to redemption of such debentures.

The wisdom of trying to attack the preferred stock bail out situation by means of a severe penalty surtax on the corporation when the stock is ultimately redeemed, the burden of which surtax may have to be borne in many cases by innocent parties who in no way benefited by or participated in such bail out, may be open to very serious question. However, this particular taxpayer is not interested in this broader question.

The taxpayer believes that in the event Congress believes it necessary and wise to enact such a severe penalty surtax, it should be very careful that the exceptions enumerated should be worded broadly enough and clearly enough to except without controversy the redemptions which should not be subject to the surtax.

The taxpayer would like to call attention to the wording of the exception contained in 309 (c) (3), which reads as follows:

"(3) NONPARTICIPATING STOCK ISSUED FOR SECURITIES OR PROPERTY.—If the transfer is in redemption of nonparticipating stock issued for securities or property (or which takes the place of nonparticipating stock which was issued for securities or property) to the extent of 105 percent of the fair market value of such property;"

In a situation where debentures, now proposed to be classified as nonparticipating stock, were originally issued in discharge of and payment of indebtedness, the taxpayer believes there is serious possibility of controversy as to whether this falls within the words "issued for securities or property."

With respect to certain other income-tax questions, many courts have held that where securities or other property were transferred in payment of an indebtedness that the transferor was not in receipt of any property, but merely extinguished its debt. The amount of indebtedness owed to patrons for patronage rebates is, of course, property in their hands, but many cases have indicated that no property passes to the debtor by payment or extinguishing of that debt.

The taxpayer wishes to suggest that this exception should be clearly and unambiguously stated to exempt from such surtax redemptions of nonparticipating stock issued in payment of indebtedness.

I wish to thank you for consideration of the objections raised by this taxpayer and to assure you that it is the desire of the taxpayer, as well as Congress, to have a fair and workable revenue code.

Respectfully submitted.

ELLIS D. BEVER.

DELAWARE STATE CHAMBER OF COMMERCE, INC.,
Wilmington, April 23, 1954.

The Honorable EUGENE D. MILLIKIN,
Chairman, Finance Committee, Senate of the United States, Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: With reference to H. R. 8300, revision of the Internal Revenue Code, please be advised this had the consideration of our Committee on National Legislation at their meeting on April 22, 1954, and desire to make the following recommendations for your consideration:

1. That the bill be endorsed, as a whole, and its passage by the Senate be vigorously urged. It embodies numerous reforms in the structure of the Federal tax laws, and is beneficial to all taxpayers, by removing many inequities and administrative and compliance difficulties; it closes many loopholes and thus protects the revenue.

2. That the method of alleviating the double taxation of corporate earnings, embodied in sections 34 and 116 of the bill, being consistent with that which has been repeatedly advocated by the State chambers, be approved, though the degree of relief falls short of that for which they had hoped, and to which they look forward.

3. That approval be given to the attempt to make more flexible the depreciation deduction as embodied in section 167 of the bill, as a step in the right direction, though the committee adheres to the position of the State chambers that, in principle, the taxpayers should be allowed to exercise discretion in the choice of method and rate, within the limits of sound and consistent accounting.

4. The committee registered disappointment that, for asserted revenue reasons, the bill fails to recognize certain firm recommendations of the State chambers. For example, the bill leaves unchanged the present law imposing a 2 percent penalty tax on consolidated corporation returns and the tax on 15 percent of intercorporate dividends. The committee's recommendation is that the State chambers, in supporting the bill as a whole, advocate the elimination of these features, which would involve the deletion of the last sentence of section 1514 (a) and appropriate amendments of section 243, 244, and 245.

5. Similarly, the extension for 1 year of the 52-percent combined rate on corporate incomes is directly contrary to the positions of the State chambers. Without receding in principle from this position, and firm in the conviction that corporate rates are too high and should not be continued at their present level beyond the date fixed in the bill, the committee recommends that the State chambers recognize the fact that the fate of the bill and the integrity of the present debt limit depend upon this provision and reconsider their respective positions accordingly.

6. The bill contains new provisions for declarations and advance payment of income taxes by corporations (secs. 6075, 6152, 6154, and 6655). This extension of the deplorable consequences of the Mills bill would amount to a further heavy increase in the tax payments of corporations with liabilities in excess of $50,000. The committee recommends support of amendments which would delete these provisions.

The committee gave attention to certain new technical provisions which call for corrective amendments and recommended support of certain of such amendments as follows:

7. The qualification provisions of the new sections affecting employees' accident and health plans (sec. 105 (c) (1) and 106 of the bill) and pension, profit-sharing and stock-bonus plans (sec. 501 (e) of the bill) are unnecessarily restrictive and are particularly burdensome to businesses having fewer than 4,000 employees. These restrictions should be relaxed so as to apply without any discrimination.

8. The policy and necessity of the detailed investment rules of section 505 of the bill relating to pension, profit-sharing, and stock-bonus trusts is seriously questioned. The general safeguards of section 504, together with those of the laws of the several States relating to the protection of trust assets, constitutes sufficient and better protection. Section 505 should be eliminated.

9. Section 309 of the bill imposes under certain circumstances a new 85-percent tax on a corporation on the redemption of its nonparticipating stock within 10 years from the date of its issuance. The section contains a subsection (c) which is intolerably harsh as applied to redeemable preferred and other stock issued prior to January 1, 1954. This subsection should be eliminated and in lieu thereof the tax should be confined to the redemption of stock issued after the

effective date of the bill. Consideration should also be given to limiting the application of the tax to closely held corporations.

10. Subsections (b) (2) and (c) (1) of section 359 of the bill impose a new condition upon the tax-free exchange of stock or property of of a closely held corporation for stock of an acquiring corporation, namely, that immediately after the exchange the shareholders of the acquired or transferor corporation shall hold at least 25 percent of the stock of the acquiring corporation outstanding prior to the transfer. This condition has no perceptible revenue or taxation purpose and should be eliminated.

Thanking you for your favorable consideration, I am, with every esteem.

Very truly yours,

GERRISH GASSAWAY,
Executive Vice President.

BALDWIN, TODD, HEROLD, ROSE & COOPER,
New York, N. Y., April 23, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
Washington, D. C.

MY DEAR SENATOR MILLIKIN: I am writing on behalf of our client, Warner-Hudnut, Inc., to invite your attention to what seems to be an unduly harsh result under the provisions of section 309 (c) of H. R. 8300. Section 309 of the bill imposes a tax of 85 percent upon the transfer by a corporation of property in redemption of its nonparticipating stock within 10 years from the date of issuance of such stock. Section 309 (c) provides that such stock shall be deemed to have been issued on the date of its issuance, or January 1, 1954, which ever date is later.

Section 309 (c) works an unwarranted hardship upon corporations that have preferred stock outstanding which was issued as a stock dividend for reasons wholly unrelated to, and completely innocent of, any "bail-out" attempt.

Specifically, the situation in regard to Warner-Hudnut, Inc., is as follows:

Warner-Hudnut, Inc., is a publicly held Delaware corporation engaged in the manufacture and sale of pharmaceutical and cosmetic products throughout the world. It has issued and outstanding approximately 1,252,000 shares of common stock, of the par value of $1 per share, and approximately 82,000 shares of preferred stock of the par value of $100 per share. The common stock is, and has been since 1951, listed and traded on the New York Stock Exchange. The preferred stock was originally issued during the period from 1925 to 1932 as a dividend on shares of the common stock of the corporation at a time when the common stock was privately held. No attempt has ever been made by the recipients of such preferred stock to use that stock as a "bail-out," through its sale or redemption or otherwise.

All of the preferred stock has been either given or bequeathed to charitable, religious, or educational organizations exempt from taxation under section 101 (6) of the code, or has been the subject of gifts upon which full gift taxes were paid.

The preferred stock has now been outstanding for a period of some 22 to 29 years. Yet, under the provisions of section 309 (c), that stock may not be redeemed before January 1964 without the payment by the company of the 85-percent tax on the redemption price. However commendable the desire to foreclose the use of the so-called bail-out practice may be, the fixing of an arbitrary date of January 1, 1954, as the date of issuance for the purpose of determining the 10-year period within which the nonparticipating stock may not be redeemed without an exorbitant price seems unnecessarily harsh. The result of section 309 (c) is to penalize corporations innocent of any attempt to utilize preferred-stock dividends for tax advantages along with those that deliberately set out to avail themselves of the "bail-out" method. Under the circumstances relating to the issuance of the preferred stock of Warner-Hudnut, Inc., and the long period during which that stock has been outstanding, it seems unduly restrictive to now provide that the company may not redeem that stock for another 10 years without prohibitive taxes.

It would appear that the Treasury is adequately protected in the general provision that nonparticipating stock may not be redeemed within a period of 10 years from the date of its issuance without the imposition of the 85-percent tax. Certainly, such provisions would serve to restrict the redemption of

relatively recent preferred stock issues and would, in all likelihood, effectively eliminate the use of such issues for tax-avoidance purposes in the future.

I therefore urge that the tax imposed by section 309 be limited to redemptions of stock within 10 years from the date of their issuance and that subsection (c) of section 309 fixing an arbitrary date as the date of issue be deleted from the bill.

Respectfully yours,

BLISS ANSNES.

THE GARRETT CORP.,
Los Angeles 45, Calif., April 20, 1954.

Senator EUGENE D. MILLIKIN,
The United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Our company, along with many other organizations similarly engaged in the aircraft industry, is deeply concerned over proposed legislation which we understand has already passed the House and is now before the United States Senate Finance Committee for their consideration. The legislation to which I refer is embodied in section 274 of the proposed Revenue Code of 1954 (H. R. 8300) entitled "Rental Payments to Governmental Units for Use of Manufacturing Facilities."

The situation in which this company presently finds itself amply demonstrates the severe financial hardship which could be inflicted on an industrial concern if this legislation is passed in its present form.

This company is principally engaged in manufacturing aircraft accessories at its Los Angeles, Calif., and Phoenix, Ariz., plants, the greater portion of which goes to the United States Government for military purposes, and secondarily engaged in the maintenances, repair, and modification of aircraft, both military and commercial.

Our corporation leases airfield and hangar space from the city of Los Angeles on the Los Angeles International Airport. Under the terms of this lease, the city has the obligation to make certain repairs and the right to improve the premises. The premises are used for manufacturing, thereby bringing us within the definition of "manufacturing articles" of said section 274.

As we understand the proposed legislation, should Los Angeles unilaterally decide to improve these premises and finance such improvements after February 8, 1954, by the proceeds of industrial development revenue bonds, not pledging the full faith and credit of the municipality for principal and interest, all rental payments we thereafter make will be disallowed as deductions for tax purposes thereby in effect doubling our rent. This would materially change the nature of our agreement and result in a prohibitive rental cost, solely because of the issuance of industrial development revenue bonds, the authorization of which had no bearing whatsoever on the original transaction and no material bearing upon any later improvements. As a matter of fact, if we sought to prevent the city from making improvements to this property, it is quite likely that we would be in breach of our lease contract. This puts us in a most untenable position—we would be the loser in either event.

This company also leases space from the city of Phoenix, Ariz., at the Sky Harbor Airport in Phoenix on which we have constructed a manufacturing plant. In addition, our lease calls for our right to use certain airfield space.

The proposed legislation is not clear as to whether the improvements need take place on the leased premises. As we read it, any improvements to adjacent municipal property financed in such a manner may conceivably be sufficient to cause a denial of the allowability of the rent as a tax deduction. Consequently, if the city improves one runway on the airport or improves adjacent or surrounding property, it may cause a forfeiture by lessees of the right to deduct rental payments on suurounding or adjacent airport property. If this is true, rental payments which we make to the city of Phoenix, Ariz., for manufacturing space we occupy on the Phoenix Sky Harbor Airport under a long-term lease could also be disallowed as a deduction.

These leases were negotiated in good faith under the assumption that rental payments would at all times be deductible as an expense of doing business. Now it seems that we, along with possibly many others in a similar position, may be unjustly penalized by a provision which seeks to remedy a condition which is in no way related to our lease agreements.

In addition, we also operate a manufacturing plant situated contiguously to the Los Angeles International Airport. If this legislation passes, expan-

sion of this facility onto the Los Angeles International Airport would place any rental payments for such space in jeopardy.

For the reasons outlined above, we respectfully request and urge that you vigorously oppose the enactment of this legislation and entreat your colleagues to do likewise. If elimination of this provision is not possible, we ask that you direct your efforts toward limiting section 274 to the conditions it seeks to correct so that it is not so broad as to prejudice the allowability of legitimate rental payments made to a State, Territory, or possession of the United States or a political subdivision thereof.

Should you desire further information regarding this matter, please call on us and we shall be glad to comply to the best of our ability.

Respectfully yours,

THE GARRETT CORP.,
W. D. MORGAN, *Vice President.*

ASSOCIATED HOSPITAL SERVICE OF NEW YORK,
New York 16, N. Y., April 19, 1954.

HON. IRVING M. IVES,
Senate of the United States,
Washington, D. C.

DEAR IRV: I thought you would be glad to have me bring to your attention a curious species of joker in the tax bill as passed by the House. They took pains to clarify the law with respect to the nontaxibility of fringe benefits. They removed any uncertainty about an employee being taxed on hospital or medical insurance premiums paid by the employer for the benefit of the employee.

Elsewhere in the bill, however, there is a curious provision to the effect that if any employee is hospitalized he will be required to pay an income tax on the moneys paid to the hospital unless he is insured by an approved plan. Approved plan refers to pension plan. The pension plans for all large companies are of course approved by the Treasury Department before they put them into effect. There are, however, thousands of smaller employers who carry hospital and medical insurance for their employees who don't have pension plans at all, approved or otherwise.

By reason of the curious new provision in the law employees of small establishments throughout the country are discriminated against. I am sure you will agree with me that the administration would be terribly embarrassed to discover that some poor employee making $75 a week may be required to pay an income tax on the amount of his hospital bill paid by Blue Cross. We annually pay to hospital bills ranging from $500 to $4,000 in amount in discharge of the Blue Cross subscriber's full hospital bill in semi-private accommodations. The public reaction would be one of shock to learn that income taxes were required to be paid by the beneficiary of our hospital service.

As you well know the Revenue Act is a document of some 800 or more pages. It is obviously impossible for the members of the House or Senate to be familiar with every possible facet of any such piece of legislation. I am sure that the result I have described above was not intended, but competent lawyers inform me that unless the Senate, or the conference committee, adopts corrective measures, the result will be as I have described to you. Accordingly I trust that you will approve of my giving you the benefit of my views on this important matter.

With warm personal regards and every good wish I am,

Very sincerely yours,

CHARLES GARSIDE.

STATEMENT OF ROBERT H. PEASE, CHAIRMAN, LEGISLATIVE COMMITTEE, MORTGAGE BANKERS ASSOCIATION, DETROIT, MICH.

This testimony is presented to the Senate Finance Committee on behalf of the Mortgage Bankers Association of America by Robert H. Pease, chairman of its legislative committee and president of the Detroit Mortgage & Realty Co.

We speak particularly in regard to section 462 of H. R. 8300, on which bill you are now holding hearings.

We request proper interpretation of section 462 of H. R. 8300, thereby enabling mortgage banking firms to level out the income received for servicing mortgages.

As an illustration of this request we will cite an example of a mortgage in units of $1,000 for a 25-year term at 4½ percent interest. The mortgage banker under

today's system (which we will hereafter refer to as the reducing income plan) will receive $4.95 per $1,000 of mortgage for his first year's work and only 18 cents for the last year's servicing fee. There is almost no difference between the actual operating cost from the first to the last year of the life of the loan and still the income for servicing will vary downward by 96 percent. We request that section 462 be interpreted to allow this same mortgage banker to credit his income account with $3 per thousand per year of mortgage principal (25 cents per $1,000 of original loan amount) for each year of the life of the loan. As mentioned above the mortgage banker receives $4.95 for his first year of servicing under the reducing income plan, and under our proposal the difference of $1.95 ($4.95 minus $3) in this illustration would be credited to a reserve account for servicing cost. This reserve account would be completely cleared out in the later years of the loan and the amount credited to income by the maturity of the mortgage would be almost identical (see schedule I).

Regardless of the interest rate, term, or servicing-fee factor, this same method of leveling income would be applicable. We have enclosed with this testimony a table which shows by comparative example each year's income under both the level income plan and the reducing income plan. This table is in units of a $1,000. We are providing the basic rates which would be used under various service fees with the level income plan. These rates are:

Servicing fee:	*Per $1,000 per month level-income factor (cents)*
1/5 of 1 percent	10
1/4 of 1 percent	12½
1/2 of 1 percent	25
3/8 of 1 percent	21¼
3/4 of 1 percent	37½

Under the level income plan the Federal Government will not have any loss of tax revenue. The total taxable income received by the mortgage banker is within a few cents of being identical for the life of the mortgage under either plan. In the event of full repayment of the mortgage under the level income plan the unused funds in the reserve account applicable to that particular mortgage are immediately returned to the income of the business. This is done by the direct procedure of debiting the reserve account and crediting the income account. The mortgage banker under the level income plan is spreading his income to equalize his costs and in no way evades or reduces the amount of his total taxable income.

The level income plan will strengthen the mortgage banking industry which is so essential to the long-term success of the FHA, VA, and the conventional loan operations. The entire system of financing home ownership is one of the bulwarks of our entire national economy and it is dependent upon the long-range services of mortgage bankers and financial institutions. The detail and extent of these services is seldom understood and for clarity we will briefly enumerate them. The mortgage banker, for example, selling a $10,000 mortgage to his principal creates a contractual obligation for 20 or 25 years. Under the existing method (the reducing income plan) he receives $49.50 for his servicing fees in the first year (at one-half of 1 percent servicing fee), $33.80 in the twelfth year and $1.80 in the twenty-fifth year.

The mortgage banker contracts to perform the following services for the entire life of the loan:

(*a*) Collect monthly payments of principal and interest.

(*b*) Collect monthly real estate tax deposits.

(*c*) Collect monthly fire-insurance deposits and/or FHA insurance premiums.

(*d*) Maintain complete accounting records both current and historical.

(*e*) Transmit these funds to his principal or to escrow accounts.

(*f*) Make periodic disbursements to city and county tax authorities.

(*g*) Maintain insurance records and pay for expiring policies.

(*h*) Maintain individual real-estate tax records and ascertain that all assessments have been paid.

(*i*) Make periodic inspections of the physical condition of the real estate.

(*j*) Furnish information to the borrower regarding the status of his mortgage and for his rights for prepayment, transfer, and settlement in full.

(*k*) Provide an organization ever ready and capable of handling the mortgage in event of delinquency and/or foreclosure.

(*l*) In the event of delinquency to furnish personal counsel and advice to assist the borrower in solving his financial problems and looking to placing the mortgage in good standing.

In elaborating on these functions of the mortgage banker we seek to demonstrate that the costs of these present and future services are well known and ascertainable. We seek to convince you that there is a cost experience which can only be offset by our proposed level income plant.

Every FHA, VA, and conventional loan must be serviced monthly for its entire life. By granting this interpretation of section 462 you would materially strengthen the mortgage banking business which forms an important segment of our entire real estate credit system. You would enable it to take its income on a realistic basis; you would enable it to level out its income so as to provide funds for payment of future loan costs instead of dissipating these funds during the earlier term of the mortgage.

The level income plan has been used for 10 years by the Bowery Savings Bank of New York City and all of their servicing contractors are under this plan. In this instance the Bowery Savings Bank of New York City holds the reserve account and pays under the level income plan for their servicing contractors. This system is not at the present time practical for the mortgage banker as he will have to hold his own reserve account and it is because of this difference that the mortgage banker needs this interpretation of section 462. An investigation of this plan with Mr. Harry Held, vice president of the Bowery Savings Bank will disclose the complete success of this level income program.

We believe that the attached table (schedule I) very clearly proves that the total income received by the mortgage banker under either plan is identical. We would like to illustrate that the total income received by the mortgage banker in the event of prepayment in full before maturity is also the same under either plan.

For example, if a $10,000, 4½ percent, 25-year loan is pay in full after 5 years, this adjustment is made:

Amount credited to reserve (½ of 1 percent) during 5 years	$235.50
Credited to income (level income plan)	150.00
Adjustment of a credit to income from reserve	85.50

This establishes very definitely that there is no loss in tax revenues either in the event the loan runs to maturity or is paid in full prior thereto.

The basic purpose of the level income plan is to provide a means of amortizing the income from servicing over the entire life of the mortgage, thereby equalizing the difference between income and operating expense that occurs under the reducing income plan.

In summarizing we believe by interpreting section 462 in our suggested maner you would be strengthening the mortgage banking industry, you would be permitting income to be realistically taken in proportion to operating costs and you would be in no way reducing the overall taxable income of the Federal Government.

ROBERT H. PEASE,
Chairman, Legislative Committee, Mortgage Bankers Association of America.

Address: 333 West Fort Street, Detroit, Mich.

SCHEDULE I (*25-year loan at 4½*)

Year	Payment	Loan of $1,000	Service fee at ½ of 1 percent reduction income plan	½ of 1 percent cumulative	Service fee at 25 cents per $1,000 cumulative level income plan
0	0	$1,000.00	0	0	0
1	$12	977.83	$4.95	$4.95	$3.00
2	24	954.64	4.83	9.78	6.00
3	36	930.37	4.71	14.49	9.00
4	48	905.00	4.59	19.08	12.00
5	60	878.47	4.47	23.55	15.00
6	72	850.71	4.33	27.88	18.00
7	84	821.68	4.19	32.02	21.00
8	96	791.31	4.04	36.11	24.00
9	108	759.56	3.88	39.99	27.00
10	120	726.34	3.72	43.71	30.00
11	132	691.60	3.56	47.27	33.50
12	144	655.25	3.38	50.65	36.00
13	156	617.24	3.19	53.84	39.00
14	168	577.48	2.99	56.83	42.00
15	180	535.90	2.79	59.62	45.00
16	192	492.41	2.58	62.20	48.00
17	204	446.92	2 36	64.56	51.00
18	216	399.34	2.13	66.69	54.00
19	228	349.57	1.88	68.57	57.00
20	240	297.51	1.63	70.20	60.00
21	252	243.07	1.37	71.57	63.00
22	264	186.12	1.09	72.66	66.00
23	276	126.55	.80	73.46	69.00
24	288	64.25	.49	73.95	72.00
25	300	0	.18	74.13	75.00

R. J. SHIPWAY & CO.,
Sioux City, Iowa, April 20, 1954.

Subject: H. R. 8300.

UNITED STATES SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

HONORABLE SIRS: H. R. 8300, now under your consideration, contains several objectionable provisions which I believe are worthy of deletion or change, and urge your attention thereto.

Section 706 of the proposed Internal Revenue Code provides that partnerships formed after June 30, 1954, must adopt a calendar year unless permission is obtained to do otherwise. The reason given by the House committee is that taxpayers may by proper selection of a partnership year defer as much as 11 months' income. While this is true, the revenue is not lost—it is merely deferred. There are many reasons other than tax considerations that warrant the adoption of a fiscal year, and the proposed restriction is only governmental interference with the individuals' conduct of their business. This proposal should be deleted.

Section 6072 provides that the time for filing be extended from March 15 to April 15 for calendar-year taxpayers. This would do nothing but delay the filing of the returns and extend the tax season for the professional tax adviser. There is no reason the average individual taxpayer cannot file his return by March 15. A suggested proposal is this: Provide that the final date of filing be April 15, but if the return is filed after March 15 assess an additional definite but reasonable amount in addition to the tax. This would eliminate the necessity of a request for extension and at the same time provide an incentive for early filing.

Section 6016 provides for current tax payments by corporations. This section should be deleted; corporations should be permitted to pay their income taxes in four equal installments in the year following the year for which the tax is assessed.

Estimating income in advance is highly impractical, as business income is very rarely earned ratably over a 12-month period. The only effect of the proposed provision is to give the Government income which is not yet earned. The budget cannot be successfully balanced in this manner.

Yours truly,

G. R. SWANSON.

SHIPMAN & GOODWIN,
Hartford, Conn., April 20, 1954.

Re H. R. 8300, Sec. 4381.

MRS. ELIZABETH B. SPRINGER,
Chief Clerk, Finance Committee,
United States Senate, Senate Office Building, Room 310,
Washington, D. C.

DEAR MRS. SPRINGER: I recently received from Berthold Muecke, Jr., of the firm of Muecke, Mules & Ireton in Baltimore, Md., a copy of his letter to you dated April 14, 1954. This included a brief of his reasons against the adoption of sections 4311 and 4381 (a) of H. R. 8300 and a proposed substitute therefor.

I am a member of the bar of State of Connecticut and of the firm of Shipman & Goodwin. I represented the taxpayer in the case of *Niles-Bement-Pond Company* v. *Fitzpatrick*, which was decided in the district court in Connecticut in 1953 and which I argued on appeal before the second circuit court of appeals last month. While engaged in this case, I have been in communication with attorneys all over the country and have read the briefs and memoranda of law in almost all the decided cases and in a number of pending cases on this subject. I have had a chance to talk to borrowers and lenders and attorneys for the Government, so that I feel the subjec raised by Mr. Muecke is one on which I am qualified to speak.

I heartily support Mr. Muecke's criticism of the proposed sections 4311 and 4381 (a). The trouble with the present law is that it contains no criteria by which the borrower or the lender can tell whether or not his instrument is subject to the tax. Faced with this problem the Internal Revenue Service has adopted an arbitrary and largely unwritten policy. Under this policy it attempts to subject large, unsecured, long-term bank loans to the tax while, as Mr. Muecke points out, it apparently does not consider a smaller loan for the same term secured by a mortgage taxable. In fact, size seems to be the main consideration for determining whether a term loan is taxable as a debenture. The number of cases pending on questions arising under the present act must be enormous. This alone should be evidence of the impossibility of the taxpayer living by or the Government administering the present law. As far as I can see, the effect of sections 4311 and 4381 (a) of the new law is to perpetuate the existing ambiguity.

The section which Mr. Muecke proposes has the virtue of clarity and preciseness. If the Congress wants to adopt a provision more stringent than Mr. Muecke suggests, I could not find fault with that. However, I think it would be unfortunate to have the present unworkable provisions virtually reenacted. Whatever policy is chosen, let us have a statute which will let everyone know where he stands.

Yours very truly,

BENJAMIN HINMAN.

1706 TELEGRAPH ROAD,
Bellingham, Wash., April 20, 1954.

ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.:

In reference to H. R. 8300, the proposed Internal Revenue Code of 1954, particularly deductions for working mother, I would like to voice my opinion.

As I understand the proposed deductions for working women with families, the deductions under consideration only apply to divorced or widowed mothers. As far as it goes I approve wholeheartedly, but I would like to express my ideas as pertaining to working wives.

I work and have one child of preschool age who is sent to a nursery school. The average cost of this per month is approximately $40. In addition, I pay income taxes of about $55 per month, also necessary clothes, transportation, etc. My husband has a job in a store that is owned by his father, and is more or less obligated to stay there because of his father's health, and at a lower-than-average salary. In order to pay our bills, acquire a home of any sort for our small family, and provide any sort of recreation at all, it has been necessary for me to work, to supplement the income. Before going to work we could not even make payments on doctor bills and hospital bills.

I don't object to paying income taxes, as I believe that it is everyone's duty to support his Government. However, I do object to the double taxation that

exists for the working mother. Any other person who is in business except the wage earner is allowed deductions for wages paid in the ordinary course of earning a livelihood. Even if working wives were allowed to deduct only the direct cost of the children's care, I believe that it would help those who have to work, and would not directly contribute to the breaking up of a home, as has been expressed by some of the Members of Congress. In my own case, it was to prevent our home breaking up that I went to work. I do not wish to work, but it is an economic necessity in our case, as in many others that I know of personally.

Very truly yours,

MRS. JUANITA BANKS.

CITY OF CHEYENNE, WYO.,
April 15, 1954.

Re revenue bill No. 274, payments to issuer of tax-exempt obligations.

HON. LESTER C. HUNT,
Senator, State of Wyoming,
Senate Office Building, Washington, D. C.

DEAR SENATOR HUNT: The city of Cheyenne wishes to go on record as opposing revenue bill No. 274 which has for its purpose the effect of making impossible the financing by State and municipal revenue bonds of industrial developments for lease to private persons.

This again is taking the privilege away from the State or municipal government to run its own affairs to the best advantage and to the best interests of the particular community and its citizens. Federal Government cannot know and should not dictate local policies. It has been the policy of this Federal administration to turn back to the States and the cities powers taken from them in recent years. Let's keep the government of the local communities in the hands of the citizens of that community.

If revenue bill No. 274 is passed, it would force a city or State to issue general obligation bonds which would directly affect the city credit rating, and we feel for projects such as this bill singles out, revenue bonds are the better way to handle it.

If an industry is brought into a community by community planning and financing, thereby making it possible for that community to expand and progress, we feel that is exploiting our basic American principle of free enterprise, and of competitive economy, and rent paid for such a building should be considered a deductible expense of business when computing income tax.

The city of Cheyenne urges you to give this matter serious consideration and to vote against revenue bill No. 274.

Very truly yours,

WORTH STORY,
Commissioner of Finance.

LITTLER, LAURITZEN & MENDELSON,
San Francisco, Calif., April 20, 1954.

ELIZABETH B. SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

GENTLEMEN: This is to call to the attention of the staff of the committee certain problems with respect to profit-sharing plans which exist under present statute and practices of the Internal Revenue Service, and which will continue to exist under the proposed Internal Revenue Code of 1954 if it is adopted in its present form. To point up the problem I shall use the profit-sharing plan of one of my clients as an example. This letter will be as brief and as nontechnical as possible.

Under the present law and the practice of the Internal Revenue Service, common pension plans established by a number of employers can be qualified, even though the employers have no relation to each other except that they may be in the same industry and under one or more collective-bargaining agreements. I believe that most common pension plans are the result of collective bargaining. I do not know of any that are not. Qualification is denied common profit-sharing plans even though the several employers are under identical ownership or where

one employer owns the others. The single exception to this is that they can qualify if the employers are an affiliated group under section 141, and then only subject to severe restrictions. Many of these restrictions appear to be modified under the terms of the proposed new tax bill.

The Service takes the position with respect to profit-sharing plans that there cannot be a common plan because an employer, under the exact language of the statute, can only contribute for his own employees and cannot contribute to a plan under which employees of another employer or corporate entity will benefit. Of course, the same language applies to pension plans. The distinction cannot be justified upon the statutory language of the present law.

Under proposed section 403 (a) (3) (B), there is specific language which would deny a qualified status to a common profit-sharing trust unless the employers are an affiliated group as defined by proposed section 1502. While I have not yet seen 1502, I assume it is similar to the old section 141.

I suggest that this is an unecessary restriction.

Take the case of my client My client is a corporation. It owns all of the corporate stock of two other domestic corporations. However, these do not file consolidated returns. It would seem that unless they avail themselves of the right to file consolidated returns as an affiliated group they could probably not establish a common profit-sharing plan as an affiliated group under 403 (a) (3) (B).

Yet, this is not entirely clear. Could they establish a common profit-sharing plan if they can qualify as an affiliated group under this section, even though they do not file consolidated returns under the other sections of the law? If the answer is "Yes," this would solve part of our problem; but it appears to me by no means certain that this is the answer.

My client has another problem which the proposed section does not resolve. The parent company also has a number of wholly owned foreign subsidiary corporations. As I understand it, these are specifically precluded from being part of an affiliated group.

From the standpoint of filing income-tax returns, it is understandable that Congress might wish to exclude foreign corporations of any affiliated group. I can thus far perceive no purpose in excluding them from a common profit-sharing plan.

From the point of view of the employees of these companies, there are potent arguments in favor of a common profit-sharing plan in this case. From time to time employees and executives move from one company to another. This is particularly true of the more valuable men who are being trained for higher executive positions. This is necessary, in any event, because all of these enterprises are engaged in highly mercurial enterprises wherein the tempo of activity varies greatly from year to year. Also, the profits fluctuate greatly and not always in ratio to the tempo of the business. It is hard to explain why these accidents must control entirely the participation in profit sharing when the employees know that in the normal course of events they are likely to be employed by more than one of these companies during their careers.

All the arguments which are applicable to the domestic subsidiaries are also applicable to foreign subsidiaries. Then there is another argument. Unsatisfactory as is the arrangement, we can set up separate profit-sharing plans for each of the domestic subsidiaries; but in the case of the foreign subsidiaries we encounter the additional problem of currency controls. This difficulty could be substantially mitigated by a common plan if the rules are not too restrictive concerning the right of the different companies to contribute to the plan based upon an inclusive formula.

It is therefore suggested that the criteria for an "affiliated group" insofar as they may be thought useful in determining when corporations may file consolidated returns are not necessarily useful in connection with the establishment and maintenance of a profit-sharing plan. The exclusion of foreign corporations is a perfect example.

We are greatly disturbed by the exclusion from proposed section 505 of the right to invest assets of the profit-sharing trust in keyman insurance. Apparently this was intentional. Thus far, I have not been able to discover in the report of the House Ways and Means Committee any reason for the exclusion.

My client is a typical case of the moderate-sized enterprise wherein the keymen are also large shareholders. It is the desire of all that upon the death of one, control shall be perpetuated within the employee group. The factors of taxation and of resources, that are so common in estate planning in this type of situation, prevail here. I need hardly expatiate upon the problem.

It has been the purpose that as soon as the profit-sharing plan were well established, with ample investments providently distributed among good securities, to commence investing funds of the trust in keyman insurance. The obvious purpose is to insure that, if necessary, upon the death of one of the keymen the trust would have sufficient cash available to purchase his stock so that it would not fall into unfriendly hands. This appears to the employees to be of the highest importance. It seems to be consistent with the concept of a profit-sharing trust. The elimination of the opportunity to purchase keyman insurance will be a sore blow to the proper expectations of the participants in the profit-sharing plan.

There may be reasons of policy for these proposed rules of which we complain, but no investigation by us has disclosed them. We do suggest that these questions merit reexamination by the staff of your committee.

Respectfully submitted.

ROBERT LITTLER,
Of Littler, Lauritzen & Mendelson.

STATEMENT OF GARNER M. LESTER, PRESIDENT, NATIONAL TAX EQUALITY ASSOCIATION, CHICAGO, ILL.; SUBMITTED TO THE SENATE FINANCE COMMITTEE APRIL 22, 1954

My name is Garner Lester. I make my home in Jackson, Miss., where I engage in farming and cotton ginning, and distribute seed and fertilizer.

In 1951, it was my privilege to appear before the Senate Finance Committee in support of legislation to remove the mantle of tax immunity from the tax-free cooperatives and mutuals. It was my contention then, and it is my contention now, that the income tax escapes permitted by section 101 and related sections of the Internal Revenue Code violate the basic principles of tax equality and also deprive the Treasury of vitally needed revenue. It is my further contention today that the changes made by Congress in the Revenue Act of 1951 are insignificant in providing revenue or tax equality and are, therefore, unsatisfactory to private business enterprise, particularly small business.

In his first state of the Union message to Congress, President Eisenhower said: "* * * the tax structure as a whole demands review * * * We must develop a system of taxation which will impose the least possible obstacle to the dynamic growth of the country. This includes, particularly, real opportunity for the growth of small businesses. Many readjustments in existing taxes will be necessary to serve these objectives and also to remove existing inequities."

Again, in his recent budget message, the President said that tax reforms are needed to "make the income tax system fairer to individuals and less burdensome on production and continued economic growth." To this end, he submitted some 25 specific recommendations which are now being considered by this Congress. After submitting these specific recommendations, the President referred to a number of other situations involving changes in the tax system which are now under study by the Treasury, and he listed among them "the tax treatment of cooperatives and organizations which are wholly or partially tax exempt."

Those statements underscore the importance of the problem I am discussing with you today. They also emphasize the fact that a question of public policy is involved in which the Congress itself should and must be concerned. I respectfully submit that while it is considering legislation to remove tax inequities generally, the Congress has a clear obligation to consider and remove one of the greatest of all inequities, namely, the substantial income-tax favoritism of cooperative or mutual corporations.

The amount of cooperative income which escapes taxation is very great. Over 40,000 profit-making cooperatives and mutuals now are permitted to avoid all, or nearly all, of the Federal income taxes that must be paid by their private enterprise competitors. In general, it may be said that these tax-privileged cooperatives fall into three groups: (1) Farmers', consumers', and retailers' cooperatives, including REA's; (2) cooperative financial institutions, such as savings and loan associations, mutual savings banks and credit unions; and (3) mutual fire and casualty insurance companies. If all of them were taxed on the same basis as other business corporations, somewhere near $1 billion in additional revenue would be paid into the Federal Treasury every year under existing tax rates.

To be specific, in a speech recorded in the Congressional Record under date of February 9, 1953, Congressman Mason of Illinois said that he had recently

asked the tax experts of the Joint Committee on Internal Revenue Taxation the following question:

"What is your estimate of possible revenue to be derived from taxing these various organizations in exactly the same way other corporations are taxed and without any consideration of their claims that patronage dividends are not income?"

Here is the answer which Congressman Mason said he received after exhaustive study by the experts of the joint committee:

"Some 6 months ago we made an estimate of the revenue which would be raised under your bill. The estimate was about $800 million, in addition to the amount resulting from the Revenue Act of 1951. It should be understood that this estimate is necessarily crude because we do not have satisfactory information on current earnings of many of the groups covered by the bill and were forced to piece together whatever data could be found."

It is reasonable to conclude that if the experts of the joint committee had had "satisfactory information on current earnings" of cooperatives and mutuals, their revenue estimates would have been even higher than $800 million. The rate of growth of cooperatives in terms of business volume has been phenomenal. As to farmers' purchasing and marketing cooperatives alone, an article in the current issue of the National Tax Journal cites Farm Credit Administration figures which show that their business volume increased from $2.5 billion in 1930 to $9.3 billion in 1949. It also quotes the executive director of Cooperative League of the United States to the effect that their business volume in 1953 had moved up to $10.5 billion.

The same steadily accelerating trend is evident in the case of the cooperative financial institutions. Since the end of World War II, according to Federal Reserve bulletin figures, there has been a 187-percent increase in the shareholder capital of savings and loan associations and a 53-percent increase in the deposits of mutual savings banks. During the same period the corresponding deposits of commercial banks increased but 40 percent. Even more startling is the fact that in 1952 the total savings flowing into some 6,500 tax-favored savings institutions exceeded, for the first time, the total savings deposited in more than 14,000 taxpaying commercial banks.

Perhaps the best way to understand the tax potential of the cooperatives would be to look at the earnings and current tax loss in the case of the large farm-supply cooperatives. I have here some figures pertaining to 25 of the principal regional cooperatives in this country. These figures were supplied by the Farm Credit Administration and therefore may be accepted as reliable. These 25 regional cooperatives, in 1952, had aggregate net earnings of $38,207,167. Their total income taxes were $2,440,815, or but 6.4 percent of their net corporate profits. Yet ordinary business corporations making exactly the same profits and in direct competition with them would have been required to pay $19,735,715 in Federal income taxes, or more than 50 percent of their net profits. Of further significance in these figures is the fact that only 7 of these 25 regional cooperatives paid any income tax at all. The other 18 paid none whatsoever.

Thus, anyway you look at it, the tax potential of the tax-favored cooperatives is enormous. At a time when Congress is looking for ways to balance the budget and at the same time reduce tax rates for everybody, this amount of new revenue should not longer be overlooked.

At this point I should like to point out that the changes which were made in the Revenne Act of 1951 fall far short of providing either substantial revenue for the Treasury or substantial tax justice for taxpaying corporate business.

In the first place, the highest revenue estimates with respect to the 1951 amendments were in the neighborhood of $28 million. Compare that with the $800 million additional which the Joint Committee on Internal Revenue has said would be realized if cooperatives and mutuals were taxed on the same basis as other corporations are taxed.

In the second place, insofar as the farmers' and consumers' cooperatives are concerned, all the 1951 act did was to tax unallocated earnings of farmers' cooperatives and to preserve the fiction that patronage dividends do not represent corporate income. Thus, the patronage-dividend loophole was kept wide open. It should be noted that an allocation can be effected by issuing "certificates of indebtedness" or "letters of advice." In either case, cooperatives can retain the cash without any tax liability whatever, and out of the retained cash resulting from tax-free earnings they can continue to expand to the competitive disadvantage of ordinary business corporations that can't escape taxes by bookkeeping entries or profit distributions.

It has been reported that cooperatives have been making extensive use of the patronage-dividend loophole. There is little to wonder about here, for what better way could there be to get a tax-free ride? It is also clear that the Treasury is not likely to get the tax from the farmer. All he may receive from his cooperative is a piece of paper which may consist of nothing more than an indefinite promise to pay something, sometime, maybe. Two recent decisions have indicated that distributions in the form of revolving-fund certificates or letters of advise are to be treated as having no tax consequences whatever to their recipients. I refer to the cases of *Carpenter* v. *Commissioner*, decided by the Tax Court on June 15, 1953, and *Farmers Grain Dealers Association of Iowa* v. *United States*, decided by the United States District Court for the Southern District of Iowa on October 28, 1953. Thus, unless there is a significant change in the law by Congress, it seems clear that this type of profit distribution will be used more extensively by all cooperatives and the very limited objective of the 1951 amendments will be wholly defeated.

In the third place, the provisions of the Revenue Act of 1951 affecting savings and loan associations and mutual savings banks likewise do not provide substantial revenue or tax equality either. The law contains provisions for the deduction of dividends and interest paid, and amounts credited to reserves to the extent that such amounts do not bring the total reserves to more than 12 percent of share or deposit liability.

As a practical matter, the reserves of most savings and loan associations and mutual savings banks do not exceed 12 percent of share accounts or deposits. Thus, these institutions will largely continue to be tax free. To show you what this means in terms of both revenue and tax equality, I need only point out that under the 1951 law the Treasury estimated that but $18 million in new revenue would be derived from the mutual savings institutions. It had previously estimated that if full taxation were applied at 1950 rates, $445 million in additional revenue would be derived, and $125 million if dividend distributions were treated as interest payments. Thus, it will be seen that these cooperative financial institutions are being taxed at but a fraction of the amount paid by the commercial banks. That is not tax justice. The taxpaying banks and the tax-favored mutual savings institutions must and do compete in the same money market. The terms of competition, because of tax treatment, are not equal by any means.

In the fourth place, there has been no change in the taxation of mutual fire and casualty insurance companies since the 1942 act was enacted. Even though that law was supposed to provide equality in the taxation of such mutual and stock companies, experience has proven that the mutual companies in the aggregate pay only about one-quarter of the income taxes that they would pay as stock companies and this payment is accompanied by many individual inequities that result from the peculiarities of the formula used for the taxation of such companies.

I might add that the 1951 law contains no provisions whatever for taxation of credit unions, production credit associations, national farm-loan associations, and REA electrification cooperatives or the REA telephone cooperatives whose expansion is currently being emphasized. Credit unions in particular have been expanding tremendously since the war.

These tax-free institutions increased from 16,000 in 1952 to 18,000 in 1953. In the same period, their outstanding loans increased from $1 billion to $1.4 billion, and their total assets from $1.7 billion to $2.1 billion. Already they are in competition with taxpaying commercial institutions in the financial field. There is no doubt that, within a relatively short time, they will expand into multimillion-dollar businesses just as cooperatives generally have done.

Thus, I respectfully submit, the provisions of the Revenue Act of 1951 relative to cooperatives, while a step in the right direction, are woefully deficient both in terms of vitally needed revenue and fundamental principles of tax equality. The time for realistic action has come.

Finally, I should like to say a word about governmental policy involved in taxing cooperatives. In this connection, let us recall a bit of history. Congress first granted cooperatives a clear-cut tax-exempt status in 1916. Then they were small and the corporate income tax was 2 percent—a negligible amount as compared with modern standards. Under such circumstances, the tax concession could be afforded on the basis of social experimentation if on no other basis.

Today, both the economic status of cooperatives and the tax climate itself have changed. The tax-favored small cooperatives have expanded into huge

cooperative corporations, some of which operate manufacturing plants and retail stores, with holding companies pyramided on top. They are in direct competition with, and in some cases are putting out of business, traditional American business enterprises which are bearing a tax burden that was undreamed of 35 years ago. In view of these facts, common sense as well as the principles of tax equity demand that we reassess governmental policy relating to their tax treatment.

In doing so, there are certain fundamental principles which I am confident we can accept. While we have all heard of the partnership allegation and the other argumentative devices by which tax-exempt cooperatives have sought to be differentiated from tax-paying business enterprises, these arguments have been rebutted effectively both by authorities in the tax field and by the tax staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department. The latter after an exhaustive study have advised this committee in a report issued in April 1951:

1. Cooperatives are corporations.
2. The Congress has full power under the Constitution to tax cooperatives as any other corporate entity.
3. The so-called net margins of cooperatives are nevertheless corporate income against which Congress has the power to levy the income tax.
4. The fact that cooperatives are obligated to provide patronage dividends does not alter the fact that net margins are income to them.

In view of these facts, I believe that all tax-privileged cooperatives should be taxed on the same basis as private business. The sections of the law which grant tax-exemptions to them should be repealed. Corporate income distributed as patronage dividends in any form should be taxed to the cooperative earning it. Cooperative financial institutions should be taxed on their net income before the distribution of dividends just as commercial financial institutions are taxed. And mutual fire and casualty insurance companies should be placed under the same rules that now govern their stock competitors.

There is no logical reason why this should not be done. Cooperatives are in the business of producing gain, profit, or income. Such gain, profit, or income is no different from that produced by the ordinary business corporation. The cooperative, in fact, is an incorporated business organization just like any other corporation engaged in business, and the members of cooperatives are no different from the shareholders of an ordinary corporation and in most instances are shareholders.

A private corporation makes a net profit which it distributes in the form of dividends. A cooperative makes a net margin which it distributes in the form of dividends on stock and patronage. In each case, regardless of how you describe it, there is a financial return to the corporate entity engaged in the business operation. To tax the one, and not the other, is to deny tax justice.

There is a growing feeling in this country, supported by court decisions, that when a nonprofit corporation enters the private competitive field for gain, profit, or income, even though no private persons share in that income, it should forfeit its right to tax-exemption. The Congress itself has already accepted this viewpoint by taxing certain income of religious and charitable institutions whose importance to the welfare of this Nation is inestimable. If such a tax policy is to be maintained in respect of nonprofit corporations which promote our moral welfare, then there can be no real economic, social, or political reason for exempting the profitmaking cooperatives which, by their own admission, exist for the financial benefit of private persons who are their members and patrons.

In closing, I wish to make it clear that I do not deny the right of cooperatives to engage in all fields of commercial business enterprise. I simply believe they can attain their objectives and at the same time bear their fair share of the burden of government. I therefore respectfully urge you to recommend and enact legislation now, requiring taxation of the business profits of cooperatives and mutuals on the same basis as the earnings of all other competitive business corporations now are taxed. Such legislation, if enacted, will help balance the budget. It will help make possible a general tax reduction. It will accomplish that equalization of the tax burden which is so desperately needed to assure a fair chance for all in American business life.

Summary of earnings and Federal income taxes paid by 25 major regional farm supply purchasing cooperatives for fiscal years ending in 1952

Regional cooperative association	Number of retail outlets [1]	Annual sales	Net income	Disposition of net income			Net worth	Percent of net income paid in taxes [4]	Federal income tax regular corporatio would pay [5]
				Federal income taxes	Dividends paid in cash [2]	Income retained [3]			
Cooperative G L F Exchange, Inc. (New York)	733	[6] $333, 355, 707	$7, 725. 848	$1, 651, 892	$4. 059, 706	$2, 014, 250	$56, 459, 033	21. 4	$4, 011. 940
Southern States Cooperative, Inc. (Virginia)	723	[6] 141, 932 393	4, 213, 776	None	1, 670, 386	2, 543. 390	30. 064. 022	None	2, 185, 663
Eastern States Farmers Exchange (Massachusetts)	533	98, 077, 412	2, 958, 963	None	1. 073, 350	1. 885, 613	[7] 23. 058, 228	None	1, 533. 160
Consumers Cooperative Association (Missouri)	1, 656	82, 441, 614	2, 849, 742	200, 448	102, 904	2, 546, 390	24, 042, 525	7. 0	1, 476, 365
Illinois Farm Supply Co	170	56, 766, 483	2, 921, 491	435, 000	2. 046, 091	440, 400	10. 237. 176	14 9	1, 513, 675
Indiana Farm Bureau Co-Op	86	135, 217, 232	2, 724, 404	None	833, 535	1, 890, 869	30, 107, 551	None	1, 411, 190
Farmers Union Central Exchange (Minnesota)	892	45, 708, 050	[8] 3, 305, 898	None	3, 282	3, 302, 616	25, 108. 344	None	1, 713, 566
Farm Bureau Co-Op Association (Ohio)	250	65, 481. 240	1, 205, 205	20, 765	445, 780	738, 660	11, 296, 667	1. 7	621, 206
Farmers Cooperative Exchange (North Carolina)	245	[6] 45, 439, 126	619, 856	None	291, 164	328, 692	6, 803, 424	None	316, 825
M. F. A. Milling Co. (Missouri)	272	33, 131. 161	1, 599, 561	None	321, 666	1, 277, 895	4, 665, 777	None	826, 271
Washington Co-Op Farmers Association	39	50, 657, 046	2, 101, 156	None	319, 812	1, 781, 344	13, 438, 700	None	1, 087, 101
Midland Cooperatives, Inc. (Minnesota)	852	28, 954, 169	467, 541	105, 000	132. 628	229, 913	10, 256, 156	22. 5	237, 621
Pennsylvania Farm Bureau Co-Op. Association	56	23, 215, 831	501, 468	None	160, 265	341, 203	5, 706, 335	None	255, 263
Pacific Supply Cooperative (Washington)	184	24, 548, 782	425, 749	None	531	425, 218	6, 468, 767	None	215, 889
Fruit Growers Supply Co. (California)	170	18, 492, 365	1, 599, 172	None	1, 599, 172	None	10, 557, 300	None	826, 069
Farm Bureau Services, Inc. (Michigan)	372	22, 158, 953	192, 618	None	31, 945	160, 673	2, 636, 580	None	94, 661
Poultrymen's Co-Op. Association of Southern California	9	16, 681, 270	992, 004	4, 995	593, 354	393, 655	1, 982, 922	0. 5	510, 342
Central Cooperative Wholesale (Wisconsin)	265	11, 193, 910	187, 520	22, 715	34, 068	130, 737	3, 058, 714	12. 1	92, 010
Arkansas Farmers Association	391	10, 288, 935	206, 337	None	6, 703	199, 634	829, 326	None	101, 795
Consumers Cooperatives Associated (Texas)	425	8, 130, 360	[9] 217, 019	None	Loss	Loss	1, 646, 284	None	Loss
Tennessee Farmers Cooperative	89	7, 904, 992	169, 711	None	31, 743	137, 968	995, 825	None	82, 749
Farmers Union State Exchange (Nebraska)	382	7, 435, 834	200, 867	None	23, 511	177, 356	2, 061, 957	None	98, 950
Mississippi Federated Cooperatives	70	12, 833, 170	346, 374	None	48, 701	297, 673	1, 771, 987	None	174, 614
Minnesota Farm Bureau Service Co	87	6, 259, 891	428, 108	None	52, 296	375, 812	1, 817, 364	None	217, 116
M. F. A. Co-Op. Grain & Feed Co. (Missouri)	129	5, 228, 565	263, 798	None	39, 570	224, 228	1, 417, 598	None	131, 674
Grand total	9, 080	1, 291, 534, 491	38, 207, 167	2, 440, 815	13, 922, 163	21, 844, 189	286, 548, 562	6. 4	19, 735, 715

[1] Includes local agent representatives.

[2] Includes patronage dividends paid in cash and dividends on common and preferred stock paid in cash.

[3] Includes patronage dividends distributed in stock, equity certificates, book allocations, etc.; and unallocated additions to capital reserves and surplus.

[4] Federal income taxes paid or indicated

[5] Does not include excess profits taxes or make allowances for depletion or other similar adjustments.

Source: Cooperative Research and Service Division, Farm Credit Administration.

[6] Includes local retail stores.

[7] Total net worth represents retained earnings.

[8] Does not include $172,457 placed in educational fund and $183,071 placed in employees' savings-sharing fund.

[9] Deficit not included in totals.

REED C. LAWLOR,
Los Angeles 14, April 20, 1954.

Re H. R. 8300, section 1221, capital assets defined.

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

DEAR SENATOR MILLIKIN: The undersigned attorneys wish to submit a few comments to you which we believe will aid you in determining whether the above-identified section of the Internal Revenue Code should be adopted as it stands or should be revised.

This section reads, in part:

"For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * * (3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

"(A) a taxpayer whose personal efforts created such property, or

"(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part, by reference to the basis of such property in the hands of the person whose personal efforts created such property; * * *"

You will probably recall that section (3), quoted above, is the Eisenhower amendment which was adopted in 1950. According to information that is publicly available, it would appear that General Eisenhower was able to obtain capital-gain treatment for income received from the sale of a book that he wrote prior to the adoption of the amendment in question. It would also appear from information publicly available that former President Truman has not been able to obtain capital-gain treatment for income received from the sale of a book which he has written since the amendment was adopted. In both cases it is clear that the authors were amateurs, and both, except for the Eisenhower amendment, should be entitled to the benefits of capital-gain treatment with respect to the sale of the works in question.

It is the view of all of the undersigned that the Eisenhower amendment should never have been adopted and that it should be repealed so that all amateur authors can obtain the benefit of capital-gain treatment from the sale of their books. The Founding Fathers of our country wanted to stimulate the progress of our civilization by encouraging inventors and authors. They provided in article 1, section 8, of the Constitution that Congress should have the power:

"To *promote* the progress of science and the useful arts by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." [Emphasis added.]

Only recently the United States Supreme Court stated in *Mazer* v. *Stein* (100 USPQ 325, 98 L. E. D. Ad. Sh. 373),

"The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that *encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in science and useful arts.* Sacrificial days devoted to such creative activities deserve rewards commensurate with the services rendered." [Emphasis added.]

It is well recognized that authors make great and valuable contributions to the happiness and progress of our country. Such contributions should not be destroyed by confiscatory taxes, but should be promoted in keeping with the spirit of article 1, section 8, of the Constitution.

If we are to encourage amateur authors to benefit all we should make it possible for them to receive substantial rewards for the services that they render to the public. We submit that one of the most effective ways to bring about such encouragement and reward in accordance with the economic philosophy of our country is to repeal the Eisenhower amendment.

We respectfully submit that the Eisenhower amendment should be repealed at this time while the Internal Revenue Code is being recodified.

Respectfully submitted.

REED C. LAWLOR,
HARRIET F. PILPEL,
New York, N. Y.
WARREN C. HORTON,
Chicago, Ill.
CHARLES F. CHISHOLM,
New York, N. Y.

AMERICAN NATIONAL RETAIL JEWELERS ASSOCIATION,
New York 17, N. Y., April 20, 1954.

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

DEAR SENATOR MILLIKIN: The American National Retail Jewelers Association was organized in 1906 and represents about 5,000 retail jewelers throughout the United States.

We come to you in connection with section 6016 of the proposed Internal Revenue Code of 1954 (H. R. 8300, the tax-revision bill). This section provides for the declaration of estimated income, and advance payments of corporate income taxes. There are two major disadvantages to the plan.

First, all corporations which will be subject to the plan (corporations with an anticipated tax liability of more than $50,000) will in effect have to sacrifice working capital to pay taxes, and will, at the end of 5 years have lost working capital equivalent to one-half year's tax bill. This is a substantial loss.

If working capital is not sacrificed, the corporation must find the money from other sources. Some publicly held corporations may be able to do this by selling additional securities, but many of the closely held family type retail corporations may have to abandon plans for expansion, etc., in order to meet the increase.

The second reason is more or less peculiar to retailing. Retail jewelers have their most profitable season at Christmas, and make a large portion of their sales in November and December. These corporations will have to make their first estimate in advance of any indication of what sort of a Christmas business they are going to have. Their second estimate will come just before inventory, and it too will be more or less of a guess.

We will be most grateful if the members of the Senate Finance Committee will arrange to have this provision eliminated from the bill. We will be glad to hear from you.

With kindest personal regards, I am,

Sincerely yours,

CHAS. M. ISAAC,
Executive Vice President.

THE DOMINION LIFE ASSURANCE CO.,
Philadelphia 2, Pa., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
The United States Senate, Washington 25, D. C.

MY DEAR SENATOR: Enclosed herewith you will find a mimeographed copy of a letter which specifically refers to section 264 of H. R. 8300, setting forth its ramifications, together with the probable end result. Also enclosed herewith you will find revenue ruling 54–94 and a photostat of section 264, together with its interpretation.

Section 115g (3) was passed in 1950 to enable the owner of a close corporation to pay Federal estate and State inheritance taxes and by providing this relief, the owner was given the opportunity to perpetuate his business rather than have it sold to provide for the payment of taxes. This measure was passed with the view of eliminating the hardships of situations such as these and to prevent large companies from buying out the smaller company at a distress sale. This section was passed to help keep the American economy sound and to prevent control which would tend toward monopolistic enterprises. Section 115g (3) enables a man to perpetuate the business that he has worked so hard to build. However, where funds are not available from the net dollar, after the payment of taxes, which is often the case, relief is still not available unless he can afford to pay the necessary life-insurance premium from his net dollar in order to provide these funds.

Close scrutiny of this section will reveal that its effects will be dangerous rather than helpful, and in reality is nothing more than a peace offering by some life-insurance companies to its agents.

You will note in the past several weeks that bank loans throughout the country have dropped in excess of a billion dollars. It is reasonable to assume that when a billion dollars is taken out of circulation, it will have some effect on the economy of the country. If the Senate is interested, and I am sure that it is, to alleviate and correct the conditions that make this possible, then serious consideration must

be given to a section which has helped to create this condition. The elimination of this section will not correct this situation in its entirety, but I assure you that it will help substantially.

Please check the enclosed matter and analyze the same, as it is of extreme importance.

Thank you most kindly.

Very truly yours,

CHARLES F. TELLER.

GENTLEMEN: In reference to section 264, of H. R. 8300, Internal Revenue Act of 1954, which section classifies the single premium annuity with single premium life and endowment contracts and further, considers an amount of future premiums approximating the single premium cost of life insurance policy to be deposited with a life insurance company for the future payment of premiums the same as a single premium policy.

Primarily, consideration must be given to the real intent of the drafters of this bill, and of course, the intent of the House Ways and Means Committee. Is the intent to stop the loss of revenue to the Government, or is it to appease some particular interests that feel the law, as it stands, has caused them some difficulty in handling a personnel problem?

Let us consider, the difference between life insurance and annuities; life insurance and endowment contracts contain the element of risk, which is based on the life expectancy of the assured. Under the present law, the proceeds collected as a death benefit is income tax free (the new act would correct this to some extent); however, the increment over the deposits of an annuity contract, if surrendered by the annuitant or owner, is taxed as ordinary income. The annuity deposits made with a life insurance company are similar to those made with a bank, except that the interest is not reported annually, but all at once at the time of surrender. There is no life insurance involved.

Because of this, it is extremely unjust to classify the annuity on the same basis. Further, it is putting an additional obstacle in the way of the person who cannot purchase life insurance and needs to have funds available for death taxes to be paid to the Federal and State Governments.

Is the purpose of this section to prevent the loss of revenue? If this is the purpose, then an examination of this will reveal that the enactment of it will cause a loss rather than prevent one.

Since the excess-profits tax is not in effect, let us consider, the person whose top bracket income is 52 percent, age 50, who has a need for $100,000 of life insurance to meet his Federal estate and State inheritance taxes. The premium for the insurance is $4,000 per year. This man does not have the $4,000 left after he pays for income taxes, yet he has a definite ned for the $100,000 or the business he has worked so hard to build during his lifetime will have to be sold to pay estate and inheritance taxes. This man cannot pay this out of capital, as his capital has been reinvested in his business in order to meet the demands of expansion. So, he pays the first year premium and arranges to borrow the money at the bank to discount the next 10 premiums, which, let us assume, would take $36,000. Now, if this man died in the 10th year his net death benefit would be $64,000, which is not adequate for his needs. If he borrowed again in the 10th year to pay for 10 more years, and let us say he died in his 20th year, the net value of his insurance would be $28,000, which of course is far less than he needs. In order to offset this, he also borrows $100,000 to purchase a single premium deferred annuity of $100,000, which annuity increases in value to help offset this decreasing amount of life insurance. The 10th year value of the annuity is approximately $120,000, which makes $84,000 total available at death after loans are paid; which at the 20th year the net death benefit is about $98,000 after the payment of the loans.

Bank interest on the $136,000 at 3¼-percent amounts to $4,481.34. The man being in the 52-percent bracket, it appears that the Government has lost $2,330.30.

Banks that make prime loans of this sort, are large banks which have been in the 52-percent-tax bracket or better, so that the Government has received from the bank on this loan an amount of $2,330.30, which immediately replaces the loss suffered from the individual, but in addition to this the Government receives income taxes from the agent who sells this plan and the general agent, both of whom are in about the 40 or 50-percent-tax bracket. Assuming the agent makes $2,000 on the annuity and $2,000 commission on the insurance, and he is in the 40-percent bracket, the Government receives the sum of $1,600 in income taxes from him. The general agent would make about $500 on the annuity and

$200 (5-percent) override on the insurance or a total of $700, which should mean $280 in taxes to the Government.

In addition to this the insurance company will net about 3.60 percent on the $136,000 or $4,896 investment income on which it is taxed at 6½ percent or the Government will receive in taxes an amount of $318.40 annually.

In addition to this, the insurance company will pay a State premium tax of 1½ to 2 percent.

Considering the total loss by the Government of $2,330.30, as to its gain under the bank loan plan above of $4,528.70, the Government has a net gain the first year of $2,198.40 and will continue to enjoy a gain of about $300 or more for each year thereafter. This gain may even be greater, as the present bill is considering a revision of the tax paid by the life insurance companies.

Further, consideration must be given to the estate tax of about 35 percent on the $100,000 life insurance policy which is part of the man's estate, together with income tax paid on the increment in the annuity.

Consider the assistance this method affords to the business economy of our country, and finally taxes collected from the beneficiaries' use of the money in the future.

Plans of this sort, have been in effect for at least the last 32 years. Why all the concern now?

What will be the effect of this section?

It will eliminate the only chance a person has of providing dollars to pay the Federal estate and State inheritance taxes and final settlement costs. Where these funds are not available, the business will have to be sold to provide the same. The price secured at a distress sale is often much less than the true value. But, of course, there is no choice as the taxes must be paid.

The end result is that investment banking groups will eventually control American business, and control of the economy of our great country will end up in the hands of a few. Section 264 will take away the only guaranteed method of perpetuating a business.

Section 115 (G) (3) affords some relief to the close corporation, but not enough to guarantee control, while no relief is offered to the sole proprietor or the partnership.

Further, section 264 will be contra to the end result sought by the antitrust laws. The inevitable result will be the concentration of wealth, power, and control of American industry in the hands of a few.

Congress, I am sure, did not intend this result.

Is section 264 attempting to set aside practices such as those set forth in Revenue ruling 54-94?

If the purpose of section 264 is to eliminate practices such as these, which have resulted in a loss in revenue, then this has been done by this ruling, and it has been done in the most effective and direct way, in which case there is no need for section 264 of H. R. 8300.

Enclosed herewith you will find a copy of this ruling.

The argument may be advanced that the picture presented in reference to the gain of revenue by the Government is not a true one, as the interest paid by the bank on the particular funds borrowed is considered a part of the top bracket of the bank's earnings. This is the only sound and true comparison that can be made if the expenditure made by the individual in the payment of interest is taken on the basis of the top bracket of his income. It would be an unfair comparison to consider the individual savings from the top-bracket income, while the bank's payment of taxes on the same received would be considered in the lower-income bracket.

Let us consider further the possibility of the attainment of another end by the passage of section 264. Are the drafters of this bill "carrying the ball" for some life-insurance companies who are attempting to appease and soothe the feelings of some of their "cry baby" agents who claim to have lost business to agents of other companies because their companies did not make available to them the discounted premium plan for the purchase of life insurance? If this is the reason, the drafters of this section are not aware of the practices and contractual rights given an agent. There is no agency contract known in the life-insurance business which will not permit an agent to place business in another company if the company he represents does not have the contract his client desires. It is a practice with life-insurance companies that a full-time agent must first submit his business to the company he represents, providing the company can issue the type of contract requested and, of course, providing the company is willing to accept it. If the company is not willing to accept his business or it does not

have the contract requested, then the agent has a right to place his business with any company that can fulfill his needs.

If these complaining agents would investigate, they would find at least 90 percent of all the life-insurance companies in the business will accept the prepayment of premiums, discount the same, and retain these premiums in a premium deposit fund. Yes; without a doubt, their companies have engaged and still engage in this practice. Maybe their companies do not sell single-premium annuities; but if they do not, by contract these agents have the right to place business with any company that does handle single-premium annuities.

The drafters of this legislation are attempting to become the "great levelers of mankind" and they are attempting to put agents on an equal footing, when they know this is impossible to do, as man is not equally endowed.

Isn't it logical to assume that a man would prefer to retain 48 cents of every dollar for his own use? Even though it is only 48 cents of every dollar, he has the right to spend it in any way he desires and to use it for anything he wishes. Isn't this better than not having even 1 cent left from every dollar? The man who buys life insurance under this plan is spending 48 cents of his money which he could use for other things. The reason he is spending this money is because he has a definite need for life insurance. He has a definite need for dollars to pay his taxes. He has a definite requirement to provide these dollars or to lose his business. If this man did not have this need, he would not part with the 48 cents of every dollar, which is what he does when he pays the bank interest.

Section 264 is legislating against this particular group. This group, as a rule, does not qualify for many of the fringe benefits, deferred compensation plans, and pension arrangements afforded under the existing laws. It does not have a market for its stock, if a corporation; it faces dissolutionment if a partnership or a sole proprietorship. However, gentlemen, the taxes must be paid.

The impact of this section requires your close scrutiny. Please accept my sincere thanks for the consideration and attention you may give this section.

[Par. 6223] Revenue ruling 54–94, I. R. B. 1954–11, 6.

Deductions: Interest.—Amounts claimed as "interest" in connection with certain so-called tax-saving plans, the purpose of which is to obtain an interest deduction for Federal income-tax purposes, are not deductible under section 23 (b) of the Internal Revenue Code.

Back references: Section 39.23 (b)–1 at 541 C. C. H., paragraph 171.1315 and section 39.23 (k)–2 at 542 C. C. H., paragraph 207.7308.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income-tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23 (b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1.—M Insurance Co. has sold to the taxpayer an "annuity savings bond" (herein called the bond) under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000: To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, i. e., the excess of the "cash value" over the unpaid balance on taxpayer's note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value."

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½-percent investment.

Example 2.—In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5 million United States Treasury 1⅜-percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small downpayment and purported to "borrow" the balance from the N Co., a dealer in se urities, on a 2¼-percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N covered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5 million of such notes at the then market price to cover its short sale.

(In come cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as "interest" in the above examples are not interest within the meaning of section 23 (b) of the code, and are not deductible for Federal income-tax purposes. Cf. *Old Colony Railroad Co.* v. *Commissioner* (284 U. S. 552, Ct. D. 456, C. B. XI-1, 274 (1932) (3 U. S. T. C. par. 800)), where the Supreme Court indicated that interest is "the amount which one has contracted to pay for the use of borrowed money."

In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest." An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See *Talbot Mills* v. *Commissioner* (326 U. S. 521, Ct. D. 1660, C. B. 1946-1, 191 (46-1 U. S. T. C. par. 9133)); *Matthiessen et al.* v. *Commissioner* (194 Fed. (2d) 659 (52-1 U. S. T. C. par. 9201)). In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums paid for the annuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24 (a) (6) of the code. In example 2, taxpayer in substance pays a sum of money to the N Co. for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows." Cf. *Commissioner* v. *Transport Trading & Terminal Corp.* (176 Fed. (2d) 570, 572 (49-2 U. S. T. C. par. 9337)), where the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

[Internal Revenue Code of 1954, H. R. 8300, 83d Cong., 2d sess.]

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS

No deduction shall be allowed for—

(1) Premiums paid on any life-insurance policy covering the life of any officer or employee, or any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single-premium life insurance, endowment, or annuity contract.

For purposes of paragraph (2), a contract shall be treated as a single-premium contract if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or if an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

[H. Rept No. 1337, of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8300]

XI. ITEMS NOT DEDUCTIBLE

A. Certain amounts paid in connection with insurance contracts (sec. 264)

Under existing law, no interest deduction is allowed in the case of indebtedness incurred, or continued, to purchase a single-premium life-insurance or endowment contract. In addition, if substantially all the premiums on a life-insurance or endowment contract, are paid with 4 years from the date the contract purchased, it is treated as a single-premium contract and the same rule applies.

Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

Your committee's bill will deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954.

In the case of life-insurance contracts, a method has been devised to avoid the limitation on the interest deduction for indebtedness on single-premium contracts. The purchaser borrows an amount approximating the single-premium cost of the policy but, instead of purchasing the policy outright, deposits the borrowed funds with the insurance company for payment of future premiums on the policy.

Your committee's bill will prevent this type of avoidance by providing that if an amount is deposited with an insurer for payment of a substantial number of future premiums on the policy, the contract will be treated as a single-premium contract. No interest deduction will be allowed on the indebtedness incurred, or continued, to purchase or carry such a contract.

LINES, SPOONER & QUARLES,
Milwaukee, April 21, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: It is desired by the undersigned to make a statement to be considered as a part of the hearings being conducted with respect to H. R. 8300. This statement of the undersigned deals with section 1235 entitled "Sale or Exchange of Patents by the Inventor."

It is a primary purpose of section 1235 to extend capital-gain benefits to inventors in order to stimulate inventive productivity to increase contributions to our technical economy and to advance useful arts. Apparently, secondary purposes of this section are to erase the difficulties that have arisen, under existing law, in distinguishing between amateur and professional inventors, and to make more definite the law with respect to patent assignments in which the purchase price is to be determined by the productivity of the patent over a period of years. It is the writer's feeling that the purpose of this section is most commendable, but that through the inclusion of subsection (e) pertaining to related persons the section is partially emasculated to a degree that its primary avowed purpose will not be satisfactorily fulfilled. Therefore, it is the purpose of this statement to show that the present subsection (e) should be stricken or, in the alternative, modified.

The primary purpose of section 1235, i. e., the stimulation of contributions for technical advancement, will be effected primarily by subsection (a) in which capital gains will be extended to inventors both amateur and professional. At present, professional inventors are deemed to hold their patents as stock-in-trade and as such these patents may not be considered as capital assets. Section 1235 changes existing law by extending capital-gains treatment to each class of inventor, if certain conditions are met in the transaction. The transfer of the property must be a complete transfer of an undivided or part interest in such property. The property must comprise a patent or a pending application, and the inventor must be the assignor. There are 2 exceptions to the requirement of a complete transfer, these being that the purchase price may be related to future productivity, and that the purchase price may extend over a period of 5 years from the date of the transfer.

These provisions of subsection (a) should do much toward the stimulation of inventive productivity. However, your attention is directed to subsection (e), which excludes certain persons from availing themselves of section 1235. By subsection (e) "related persons" as defined in section 267 (b), with the exception of brothers and sisters, are placed outside the application of subsection (a). Primarily, related persons include members of a family (spouse, ancestors, and lineal descendants), and an individual and a corporation in which more than 50 percent of the stock is owned, directly or indirectly, by the individual. Stock held by members of the family is considered as held for or by the individual. This exclusion of "related parties" extends to a very large segment of our inventive population that is in a position to dispose of acquired patents, as distinguished from employees hired to invent.

A goodly number of inventors, both amateur and professional, initiate and develop a personal business individually, or in close association with others, during the course of their lifetime, and their talents consequently become peculiarly and intimately associated with such business. It results that their talents are necessarily channeled exclusively in the direction of this business, which has been the focal point of most all their working hours. The useful productivity of these persons knows no other business.

While statistics are not available, it is manifest that this class of inventors is quite large and that they are associated with both large and small enterprise. Furthermore, this class of inventors has in the past made many great and welcome contributions to our technical advancement. It is particularly important that this group of inventors have the benefits of section 1235 extended to them in the absence of compelling reasons to the contrary. It is a basic tenet that our tax laws should treat all persons fairly and on an equal basis without unjust discrimination. It is submitted that subsection (e) does not carry out this tenet.

In reports accompanying bill H. R. 8300 the statement is proffered that in nonarm's length transactions abuses may arise where dealings are between members of the same economic group. To avoid such abuses a broad exclusion of all dealings between "related parties" is made, regardless of absence or presence of arm's length transactions, or regardless of whether the dealings are identical in result to arm's length transactions that might be arranged with others.

Because members of a family are involved, such as in an instance of father and grown sons owning proportionate shares of a corporation, it does not follow that non-arm's length transactions or abusive transactions result from dealings between them. To the contrary, personal motivations cause each to scrupulously survey acts of the others. Subterfuge is not the common result of dealings between these parties, nor should it be so assumed.

Whether parties are related is not a true test. This is artificial, and to exclude this group of inventors in blanket fashion puts them at a distinct and unfair disadvantage. The inventive talent of these inventors usually has only a small area of marketability since their efforts are directed solely toward the particular business in which they are engaged. They must deal with a business or individuals that are related if they are to dispose of their original patents at all. The only alternative is making transfers to direct competitors. Manifestly a course that will not be taken.

Would not a fair test, in striving to eliminate abuses, be a determination that the terms of a transaction are equivalent to those which would be arrived at in an arm's-length transaction? If the taxpayer-inventor can show that his transfer to a related party was in fact an arm's-length transaction, or for a consideration equivalent to that which would be obtained in an arm's-length transaction with others, should he not be entitled to avail himself of section 1235? He has

contributed to our technical advancement as well as an inventor dealing with a nonrelated party. It appears that there is no just reason under these circumstances to discriminate against the one who finds himself in the position of necessarily dealing with a related party. This would appear only right since transactions between brothers and sisters are expressly excluded.

As a conclusion, it is submitted by the writer that subsection (e) should be eliminated, particularly in view of the fact that if abuses do become rife, a similar provision can, at a later date, be inserted. As an alternative, the following might be added to subsection (e):

"* * * unless the transaction was made at arm's length, or resulted in terms as to consideration that would have been arrived at in an arm's-length transaction."

Further, it should be remembered that in creating subsection (e), as presently constituted, inventors, who are peculiarly tied to related persons are placed in a more disadvantageous position than they occupy under present law. And this is done without any showing of abuses having occurred. Under present law, if the inventor finds himself to be an amateur inventor, he may transfer his patent and receive a capital-gain benefit. However, subsection (e) will no longer entitle such party to treat his patent as a capital asset. Thus this inventor will be stifled more so than he is today. In this not a direct negative to the espoused purpose in creating section 1235?

It is believed that this statement touches upon a problem of considerable importance and that thoughtful considerations be given to it. It is strongly urged that steps be taken to place the inventor dealing with related parties in a more equitable position than the present draft of section 1235 would do.

Very truly yours,

ARTHUR H. SEIDEL.

ROBERT F. SPINDELL,
Chicago 3, Ill., April 21, 1954.

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

MY DEAR SENATOR MILLIKIN: The most significant part of this letter is that Lloyd Kennedy, chairman of the American Bar Association Committee on Income Taxation of Estates and Trusts, which had so much to do with recommending changes in those sections of the income-tax law, believes that the 5-year throwback rule in sections 661 to 668 of H. R. 8300 is completely unworkable. Mr. Kennedy is a member of the Chicago Federal Tax Forum, of which I am also a member. He delivered a paper before the forum last Wednesday, in which he tried to explain the operation of the 5-year throw-back rule. I am enclosing a mimeographed copy that he prepared and gave to the members to illustrate how the simplest possible type of case would operate under the new provisions. This illustrates the unprecedented complexity of the law in a simple case.

By virtue of 2 years of hard work on this committee, Mr. Kennedy knows probably more than any other member of the bar about the problems involved in a throw-back rule. He said that the American Bar Association proposal, which was not adopted went to the very limits of complexity. He said the committee felt that if even one more complication were added, the thing would fall of its own weight. Yet the Treasury's proposal is ever so much more complicated. He said that if the usual type of case involving a capital gain by a trust, or tax-free income received by a trust or a charitable contribution by a trust, were involved, even the most expert tax lawyer in the United States would find it almost impossible to work out the computation. Mr. Kennedy's unequivocal view is that the proposed provisions just will not work in practice.

The Chicago Federal Tax Forum consists of 18 of the principal tax lawyers in Chicago, heads of the Tax Departments of Arthur Anderson & Co., Ernst & Ernst and Price-Waterhouse and professors of taxation at Northwestern University and Chicago University Law School. Practically all of this group was present and it was the unanimous consensus of opinion that the proposed 5-year throwback provisions were probably the most incomprehensible they had ever read in the tax laws in their many years of experience.

I, myself, a Federal tax lawyer for more than 20 years, have read the 5-year throwback provisions a half dozen times and, while I understand what the provisions are seeking to accomplish, I have been confused as to its operation. I looked for some help in the committee report and when I finished reading the

examples set forth in the report I was even more confused. How the provisions would appear to lawyers who are not tax specialists and to the employees of trust companies who would have to administer them, I cannot imagine. Indeed, in my humble opinion, these provisions are so detailed and so complicated that they will be virtually inoperative and will be productive of considerable litigation for the Treasury and the Tax Board. They are simply beyond the comprehension of the average taxpayer and average revenue agent who will be charged with their administration.

In short, I believe that the bill as now written is more complicated and more obtuse than any other piece of legislation I have ever read in the tax laws, which it has been my business to study during the last 20 years.

Now let us look and see if the loophole which the 5-year throwback provision is designed to close is really a substantial one or a minor one. To what are we applying this strong medicine? Are we using a shotgun when a fly swatter would do? I have asked the trust officers in the trust departments of the six large Loop banks whether they have done very much in exercising their discretion, where they have power to distribute or accumulate income, so as to obtain tax savings for the beneficiaries of trusts they administer. I am personally acquainted with these trust officers and know them to be high-minded individuals. They have advised me in which I consider to be in complete good faith that there has been only slight consideration of income-tax savings when exercising discretion in such cases. In the great majority of trusts the beneficiaries have need for the income and it is distributed every year without regard for the 65-day rule. In another group of cases, where all or part of the income is to be accumulated, it is only occasionally that the beneficiary has need for a distribution of corpus which consists of accumulated income. In such cases the distribution is based on need and not on income-tax savings Mr. Don H. McLucas, vice president of the Northern Trust Co., which is one of our leading trust companies, has permitted me to use his name in this letter and to quote him as follows:

"We in the trust department have checked with each other to find out how many times, if any, since 1942 we, as trustee, have exercised discretion, where we have power to distribute or accumulate income, so as to take advantage of the 65-day rule in the manner mentioned in the House committee report. We found that we had done this in only one case and there were unusual circumstances surrounding it. We believe the abuse or tax avoidance at which the 5-year throwback rule is aimed is virtually nonexistent so far as we are concerned."

In other trust companies they said there were a few occasions over the years when they held the trust income for more than 65 days and then distributed it. But they said the amount of tax saving involved since 1942 was very small.

Out of my discussions with the trust officers developed the idea that if you changed the 65-day rule to a 12-month rule, there would be practically no tax avoidance. For, while there would be a temptation by a few taxpayers to wait 65 days, very few of them would wait a year. I have spoken to other tax lawyers about this idea and they feel the same as the trust officers.

Therefore, if you could substitute a 1-year rule for the 65-day rule, you could eliminate the 5-year throwback and adopt a workable law. And all with little or trifling loss to the Treasury.

I feel it would be both interesting and helpful to you to have a few words about the history of the throwback rule. It was proposed by the committee on income taxation of estates and trusts of the Federal taxation section of the American Bar Association. At the meeting in Boston there was a terrific argument and the final vote was about 55 percent to 45 percent, if not closer. Since the meeting was in the East the members of the section present were largely from that area, and particularly from New York and Boston. The New York Bar Association has been more prominent than anyone else in advocating the throwback rule. Most laymen do not realize the reason for this, which is a selfish one and is as follows:

Under the New York law, accumulations beyond the minority of the beneficiaries of trusts are prohibited. This means that grantors and testators wishing to provide for the accumulation of income until children reach a more mature age of 25 or 30 are inclined to consider appointment of trust companies outside of New York. Accordingly, the trust companies and their lawyers are strongly in favor of adopting a rule which will destroy or severely limit the advantages of trusts in other States which permit the accumulation of income beyond the minority of beneficiaries. That is why they have so strongly advocated and supported the throwback rule. This point can be verified by appropriate inquiry.

You appreciate, of course, that I am not basing my objection on the motive behind the rule. If it were a desirable rule and were properly drafted without causing a breakdown in its administration, then I would be for it. My major criticism, and in complete truthfulness I tell you, is that every tax lawyer and trust officer with whom I have conversed regarding this, totaling probably 35 or 40, believe that the present throwback provisions are both incomprehensible and unworkable. If you or any lawyer friend of yours will read these provisions at home one evening, together with the committee report, I am sure that the next morning you would advise your associates that what I have said above is an understatement.

In conclusion, I think it would be most unfortunate to insert such unsatisfactory provisions into what is otherwise an amazingly fine piece of legislation.

With kindest regards, I am,

Yours very truly,

ROBERT F. SPINDELL.

ROBERT F. SPINDELL,
Chicago, Ill., April 22, 1954.

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

DEAR SENATOR MILLIKIN: In my letter to you of yesterday regarding the 5-year throwback rule, I stated that I was enclosing a sample calculation prepared by Lloyd Kennedy, chairman of the American Bar Association committee on income taxation of estates and trusts. My secretary neglected to enclose the example and I am sending it to you herewith.

As stated in my letter, Mr. Kennedy, who probably knows more about the application of the throwback rule than any other person, and all members of the Chicago Federal Tax Forum believe the present Treasury version to be both incomprehensible and completely unworkable. The enclosed example is the simplest possible example and you will see from it that it requires many hours of concentrated effort by an expert tax lawyer just to handle it. When the usual complexities of (*a*) tax-free interest, (*b*) capital gains, and (*c*) charitable contributions are added, the application of the rule becomes so complicated that it is doubtful that if even an expert could apply it. It seems most unfortunate to destroy the magnificent legislative job in H. R. 8300 by including something that is more complex and difficult to understand than any tax legislation ever before proposed.

I do hope that you will give your earnest consideration to eliminating the throwback rule and the adoption of a 12-month rule instead of the present 65-day rule. As I pointed out, the amount of tax avoidance under the present law is very small, and if a 12-month rule thereon is substituted for the 65-day rule the tax avoidance would become almost nonexistent.

Thanking you for your kindness in considering this matter, I am,

Yours very truly,

ROBERT F. SPINDELL.

H. R. 8300, SUBCHAPTER J, ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

SIMPLEST POSSIBLE EXAMPLE OF THROWBACK UNDER SUBPART D

Section 665 (d). The throwback does not apply to any taxable year of the trust beginning before December 31, 1953. Hence it does not apply to accumulations of income in 1953 and earlier years.

Hypothetical facts

Trust is reporting on the calendar year cash-receipts basis.

Trustee must pay $5,000 each year to A and has discretion to pay income or corpus to either A or B, or both.

A is single, has no income except from the trust ($5,000), and paid a tax for 1954 (on $3,900) of $818.

B is single, had an income of $5,600 from outside sources (total $8,600), and paid a tax for 1954 (on $7,140) of $1,702.

Neither A nor B have any 1955 income except from the trust.

1954

Section	Item		Amount
643 (a)	Distributable net income of trust		$20,000
661 (a) (1)	Currently distributable income to A	$5,000	
661 (a) (2)	Discretionary payment to B	3,000	
			8,000
	Balance subject to tax		12,000
	Tax on $12,000 paid by trustee		3,362
665 (a)	Undistributed net income for 1954		8,638

1955

Section	Item		Amount
643 (a)	Distributable net income of trust		20,000
661 (a) (1)	Currently distributable income to A	$5,000	
661 (a) (2)	Discretionary payment to A	10,000	
661 (a) (2)	Discretionary payment to B	12,000	
661 (a)	Limitation on trust deduction	27,000	20,000
	Balance subject to tax		None

Accumulation distribution in 1955

Section	Item		Amount
665 (b)	The amount by which the sec. 661 (a) (2) deduction		$22,000
	Exceeds distributable net income	$20,000	
	Reduced by sec. 661 (a) (1) deduction	5,000	
			15,000
	Accumulation distribution of 1955		7,000

Allocation of 1955 accumulation distribution to 1954

666 (a) The 1955 accumulation distribution is not treated as if it were a section 661 (a) (2) deduction of the trust in 1954 — $7,000

Plus

666 (c) An amount equal to the 1954 taxes of the trust "multiplied by the ratio of the portion of the accumulation distribution ($7,000) to the undistributed net income ($8,638) of the trust for such year" — $\frac{\$3,362 \times 7,000}{8,638}$

or

$$\frac{\$7,000 \times \$3,362}{\$8,638} = 2,724$$

Accumulation distribution allocated to 1954 — 9,724

Tax of trust in 1954 under throwback

Section	Item		Amount
643 (a)	Distributable net income of trust in 1954		$20,000
661 (a) (1)	Currently distributable income to A	$5,000	
661 (a) (2)	Discretionary payment to B	3,000	
661 (a) (2)	Accumulation distribution to A and B	9,724	
			17,724
	Balance subject to tax		2,276
	Tax which would have been paid on $2,276		448
667	Refunds to trust denied ($3,362 minus $448)		2,914

Allocation between A and B for 1955 before throwback

662 (a) (2) From the $27,000 total distribution in 1955, A and B each include an amount which bears the same ratio to that part of distributable net income ($20,000) which is not currently distributable ($15,000) as the non-currently distributable amounts received by each ($10,000 to A and $12,000 to B) bears to the aggregate ($22,000) of such amounts.

for A this would be $\frac{X}{\$15,000}=\frac{\$10,000}{\$22,000}$, or	$6, 818
for B this would be $\frac{X}{\$15,000}=\frac{\$12,000}{\$22,000}$, or	8, 182
Total	15, 000

Before throwback A reports:

662 (a) (1)	Currently distributable income	$5, 000
662 (a) (2)	Allocation of discretionary payment	6, 818
	Total for A so far	11, 818
662 (a) (2)	Before throwback B reports	8, 182
	Distributable net income for 1955	20, 000

Allocation of throwback between A and B

668 (a) How is the throwback accumulation distribution of $9,724 allocated between A and B? H. R. 8300 does not say.

It could be either 15/27 to A and 12/27 to B, or, since $5,000 is a mandatory payment to A, on the basis of 10/22 to A and 12/22 to B. The provision in section 662 (a) (2) relating to the allocation of distributions in excess of distributable net income indicates that the latter allocation would have been chosen by Congress if the point had been considered.

Assuming the latter will be correct, either by amendment or by litigation, the allocation will be:

10/22 of $9,724 to A	$4, 420
12/22 of $9,724 to B	5, 304
Total	9, 724

Tax effect on A

668 (a)	Tentative 1955 tax computed on:	
662 (a) (1)	Currently distributable income	$5, 000
662 (a) (2)	Allocation of discretionary payment	6, 818
	Subtotal	11, 818
668 (a)	Throwback distribution	4, 420
	Total	16, 238
	Less: Exemption and standard deduction	1, 600
	Taxable income	14, 638
	Tentative tax on $14,638	4, 560
	Tentative tax on $11,818 (minus $1,600)	2, 723
	Tentative 1954 tax computed on:	
661 (a) (1)	Actual distribution in 1954	5, 000
668 (a)	Throwback distribution	4, 420
	Subtotal	9, 420
	Less: Exemption and standard deduction	1, 542
	Taxable income	7, 878
	Tentative tax on $7,878	1, 923
	Tax paid for 1954	818
	Attributable to throwback	1, 105

Tax effect on A—Continued

Section	Item	Amount
668 (a)	1955 tax without throwback	2,723
	Total 1955 tax before credit	3,828
668 (b)	Less: Credit for 10/22 of $2,914 tax of trust in 1954 which would not have been paid if trust had distributed $9,724 more in 1954 than its actual distribution	1,326
	Tax of A for 1955	2,502

Tax effect on B

Section	Item	Amount
	Tentative 1955 tax computed on:	
662 (a) (2)	Allocation of discretionary payment	$8,182
668 (a)	Throwback distribution	5,304
	Total	13,486
	Less: Exemption and standard deduction	1,600
	Taxable income	11,886
	Tentative tax on $11,886	3,357
	Tentative tax on $8,182 (minus $1,418)	1,518
	Tentative 1954 tax computed on:	
661 (a) (2)	Actual distribution in 1954	3,000
	Other income	5,600
668 (a)	Throwback distribution	5,304
	Total	13,904
	Less: Exemption and standard deduction	1,600
	Taxable income	12,304
	Tentative tax on $12,304	3,531
	Tax paid for 1954	1,702
	Attributable to throwback	1,829
668 (a)	1955 tax without throwback	1,518
	Total 1955 tax before credit	3,347
668 (b)	Less: Credit for 12/22 of $2,914 tax of trust in 1954 which would not have been paid if trust had distributed $9,724 more in 1954 than its actual distribution	1,588
	Tax of B for 1955	1,759

COMMENTS

1. Except for a trust with a single beneficiary, the foregoing example is the simplest example of the operation of the throwback which can be given.

If the trust has a charitable beneficiary, has capital gains or losses, tax-exempt interest, extraordinary cash dividends or taxable stock dividends, foreign income, or (if the new partial exclusion of dividends received, sec. 116, becomes law) ordinary dividends on corporate securities, the computations increase in complexity. Also if the accumulation distribution (the throwback) exceeds the undistributed net income of the trust for its preceding year, recomputations of the beneficiaries' tentative tax in the earlier years, up to the fifth preceding year, must be made.

2. Section 668 (a) includes the amount of the throwback distribution in the income of the beneficiary for the current year, but contains a limitation that the tax attributable to this inclusion shall not exceed the tax which would have been payable by the beneficiary had the throwback distribution in fact been made in the earlier year or years. In the example "Tax effect on B," the 1955 tentative tax of $3,357 is limited to $3,347 because the tax attributable to the throwback in 1955 ($3,357 minus $1,518) is $1,839, whereas the tax attributable to the throwback if received and taxed in 1954 is $1,829, or $10 less.

Had B had $10,000 of outside income in 1954, instead of $5,600, his 1954 tax attributable to the throwback would have been $1,980, and since the limitation would not apply, his 1955 tax would be $3,357, or only $10 higher, although his 1954 income was $4,400 higher.

STATEMENT ON BEHALF OF PENNSYLVANIA BAR ASSOCIATION RE SECTION 505 (7) OF THE REVENUE CODE OF 1954 (H. R. 8300)

I. Section 505 deals with allowable investments for exempt employees' trusts. By proposing this section Congress has for the first time shown legislative concern for the soundness and wisdom of the investments of an employees' trust. It is urged that this field should not be entered. By legislating investment restrictions Congress will give employees the impression that there is some special quality level in the investments of employee trusts. The impression will not be true unless Congress goes the much further step of examining and supervising employees' trusts in much the same way in which the Comptroller of the Currency supervises banks.

II. Even if the general idea of regulating investments in employees' trusts is retained in H. R. 8300, paragraph (7) of section 505 should be revised. As presently written, paragraph (7) allows investment in "Securities, limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust * * *."

Moreover, paragraph (5) would indicate that "securities of regulated investment companies" are not subject to the 5-percent limitation; that is to say, such securities may be bought without limit.

It is urged that not only should securities of regulated investment companies be exempt, but also common trust funds operated by banks and trust companies. In many cases a small employees' trust can obtain practical diversification only by investing in a common trust fund, which in recent times has become a familiar investment medium. All large trust companies have them. It is suggested that the following wording of paragraph (5) of section 505 would take care of the point: "(5) securities of regulated investment companies (as defined in section 851) or interests in a fund maintained by the trustee of the trust for the collective investment of trust funds."

III. Paragraph (4) of section 505 permits investment without limit in the "securities of the employer which established the stock bonus, pension, or profit-sharing plan of which the trust is a part, or securities of a parent or a subsidiary corporation of such employer."

This language does not take care of the situation where the employees' trust buys trust certificates representing the employer's stock as in the case where the stock is in a voting trust. It is suggested that the following wording of paragraph (4) would be desirable: "(4) securities of the employer which established the stock bonus, pension, or profit-sharing plan of which the trust is a part, or securities of a parent corporation or a subsidiary corporation of such employer, or an interest in a trust holding exclusively cash and securities of such employer, its parent, or subsidiary."

Respectfully submitted.

H. OBER HESS,
Chairman of Federal Tax Committee.

BANK OF GILES COUNTY,
Pearisburg, Va., April 20, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SIR: Our board of directors at its last meeting, on April 15, 1954, passed a resolution, copy of which is enclosed and which is self-explanatory.

We sincerely trust that you will use your influence to eliminate the unfair advantages granted savings and loan associations, mutuals, and cooperatives in bill H. R. 8300 now being considered by your committee.

Yours very truly,

R. L. WHITESEL, *Cashier.*

Whereas there is now pending before the Finance Committee of the United States Senate, a bill passed by the House of Representatives to revise the Federal tax laws, which is officially known as H. R. 8300, which bill specifically provides for the continuance of the unjust income tax exemption of the Federal savings and loan associations, cooperatives, and mutual businesses contrary to the best interest of a vast majority of the people of the United States: Now, therefore, be it

Resolved, That the board of directors of the Bank of Giles County, Pearisburg, Va., go on record as opposed to the continued tax exemptions, in whole or in part, of the Federal savings and loan associations, cooperatives, and mutual businesses and hereby reiterate our belief that all taxpayers should be assessed on an equal basis and any taxes so assessed be collected without fear or favor; and be it further

Resolved, That a copy of these resolutions be mailed to Senator Harry Flood Byrd, Senator A. Willis Robertson, and Representative William C. Wampler and to each of the correspondent banks of the Bank of Giles County and the following members of the Senate Finance Committee; Eugene D. Millikin, Hugh Butler, Edward Martin, John J. Williams, Ralph E. Flanders, George W. Malone, Frank Carlson, Wallace Bennett, Walter F. George, Edwin C. Johnson, Clyde R. Hoey, Robert S. Kerr, J. Allen Frear, Jr., and Russell B. Long, requesting and urging that they do all in their power to correct the unjust and unfair provisions of H. R. 8300 and to use their great influence to pass legislation that will compel all taxpayers to be taxed on an equal basis.

GENERAL PUBLIC UTILITIES CORP.,
April 21, 1954.

Senator EUGENE D. MILLIKIN,
Chairman of the Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: The purpose of this letter is to call your attention to a modification which we believe should be made in the provisions of H. R. 8300 dealing with the foreign tax credit. Overall, the provisions of the bill affecting income derived from foreign sources, and particularly the 14 point rate reduction will, we believe, encourage investment abroad and will tend to eliminate some of the existing Federal income tax barriers to foreign trade. However, there is one important respect in which the foreign tax credit provisions of the bill are deficient, namely, in failing to allow a credit for exchange taxes and fees levied by some countries in converting foreign currencies into American dollars.

A case in point is the investment of Associated Electric Co., a wholly owned subsidiary of General Public Utilities Corp., in Manila Electric Co. and Escudero Public Service Co. Associated Electric Co. holds all the preferred and common stock and ₱8 million of debentures of Manila Electric Co. and all the common stock of Escudero Public Service Co. The Philippine Islands National Government imposes an income tax ranging from 20 to 28 percent on interest and dividends paid to foreign corporations, which is allowable as a credit against United States income tax. In addition, however, before the interest and dividends paid by the Philippine Islands companies can be taken out of the country in United States dollars, an exchange tax of 17 percent and a three-fourths of 1 percent exchange fee are required to be paid on the conversion of pesos into dollars. Because of doubt as to whether the exchange tax qualifies as an income tax under section 131 of the code, there is serious question as to whether the tax qualifies for the foreign tax credit. While there may be a technical distinction between an income tax, as applied to interest and dividends, and an exchange tax and fee on such income, the latter must be paid before the interest and dividends can be converted into dollars and withdrawn from the Philippine Islands, so that economically there is no difference between the income tax and the exchange tax and fee. In our opinion, such exchange taxes and fees should be given the same treatment for foreign tax credit purposes as are income taxes.

Accordingly, we urge your committee to modify section 901 of H. R. 8300 so as to include within the definition of "income taxes" allowable as a credit under section 901 (b) (1) (A), taxes and charges imposed by a foreign government on the conversion of foreign currency into dollars or on the withdrawal of interest or dividends from a foreign country.

Respectfully yours,

H. A. BUSCH,
Vice President.

ILLINOIS AGRICULTURAL ASSOCIATION,
Chicago 11, Ill., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Recently one of our members secured a ruling from the Internal Revenue Service relative to the deductibility of drainage district assessments. He operates a farm in a drainage district on the Mississippi River.

At the time this district was incorporated years ago, bonds were issued to pay for the original capital improvements and the installation of pumps. Thereafter, these pumps became obsolete and new pumps were installed, bonds again being sold to finance the cost. These latter pumps are now old and must be replaced within a few years.

The law is clear as to the deductibility of assessments paid for the purpose of maintenance and for interest on the drainage district bonds. The ruling mentioned above pertained to that part of the assessment which was used to amortize the bonds to the extent that the proceeds of the bonds had been used in the purchase of the pumps. It was the contention of our member that inasmuch as the property purchased by the bond issue was depreciable property, the assessments paid to retire the bonds should be deductible. The Internal Revenue Service ruled otherwise and we enclose a copy of the ruling. The effect of this ruling is to penalize the farmer who belongs to a drainage district as against a farmer who is financially able to own his own drainage equipment. Without question, the latter can deduct the depreciation on his equipment.

There are a considerable number of farmers in Illinois and in other States who operate their farms in drainage districts. The same rule also should apply to farmers who belong to irrigation districts.

It would seem to me that this is a proper subject for legislative tax relief and should be considered by your committee in connection with the pending revenue act.

Very truly yours,

ILLINOIS AGRICULTURAL ASSOCIATION,
CHARLES B. SHUMAN, *President.*

UNITED STATES TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, April 12, 1954.

Address reply to Commissioner of Internal Revenue and refer to T:R:I, HBF-3.

Mr. DEXTER CUMMINGS,
Chicago, Ill.

DEAR MR. CUMMINGS: This is in reply to your letter dated March 5, 1954, referring to office letter dated February 25, 1954, relative to the treatment, for Federal income-tax purposes, of the cost of certain pumps and motors which will replace the present pumps and motors in the Lima Lake Drainage District, in which you own and operate farms.

You state that since the useful life of the pumps is 17 years and the life of the bond issue is also 17 years, under the straight-line theory of depreciation the annual assessments which you pay equals the allowable depreciation, and you request, therefore, that you be permitted to deduct these assessments for Federal income-tax purposes.

Section 23 (c) (1) of the Internal Revenue Code provides that in computing net income there shall be allowed as deductions taxes paid or accrued within the taxable year, except (E) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

Upon the basis of the foregoing provision of law, it will be seen that the only deductions allowable to the taxpayer paying the annual assessments are those for interest and maintenance charges.

Since the depreciable assets in question are the motors and pumps, which will be owned by the drainage district, there is no basis upon which a deduction for depreciation may be taken by the members against whom the assessments are made.

Very truly yours,

LESTER W. UTTER,
Chief, Individual Income Tax Branch

G. DARLING,
New York 10, N. Y., April 21, 1954.

MRS. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: I am writing to you in connection with H. R. 8300, the proposed Internal Revenue Code of 1954.

Last fall I wrote to the Joint Committee of Internal Revenue Taxation with this suggestion that the fair market value of any services or facilities received in addition to salaries, wages, etc., should be added to the monetary compensation for tax purposes unless it can be shown that no financial gain was derived from the services or facilities. Mr. Colin F. Stam, Chief of Staff, was kind enough to write to me on April 2, 1954. He pointed out that my letter was considered in connection with the revision of the Internal Revenue Code as incorporated in the bill H R. 8300.

Mr. Stam pointed out that this bill provides that meals and lodging are to be excluded from the employee's income if they are furnished at the place of employment and if the employee is required to accept them as a condition of his employment.

I would like to point out at this time that I have never in my long experience dealing with Government officers and officials received a letter which was so detailed, reasonable and explanatory. I cannot but express my admiration and respect for Mr. Stam's explanation.

However, I would like to point out again that the main reason why the bill H. R. 8300 provides that meals and lodging are to be excluded from the employee's income was that it would be very difficult to administer the law if the fair value of meals and lodging are included. However, we consider that the Government by excluding the fair market value of any services or facilities received in addition to salaries, wages, etc., stands to lose a tremendous amount of money in taxes, the administration of such law cannot be too difficult. In addition it opens a way of paying additional salaries and wages in form of facilities or services which will be completely excluded from taxation, and not only cause the loss of taxes but also put the personnel so paid in a very advantageous position. Additional difficulty in having the value of services of facilities excluded from taxable wages and salaries is that up to now the FICA requires that such facilities and services be added to the monetary compensation in order to calculate the social security tax. Furthermore, while I am not aware of the laws existing in the other States, the State of New York requires that the value of services and facilities are to be added to the monetary compensation to calculate the State income tax. Therefore, the employers have to do a much more complicated and costly job by keeping several sets of records in order to comply with the Federal and State calculations. Whereas, if the fair or any other value of services and facilities are to be included in taxable wages and salaries, it would require only one set of records.

It is also a known fact that in order to attract people some organizations may very well state that "the employee is required to accept such lodging and meals and that it is a condition of his employment."

I very earnestly ask that the Senate Finance Committee would consider these questions before the bill is reported out by it.

Very truly yours,

G. DARLING.

SAN FRANCISCO, CALIF., *April 22, 1954.*

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

I am attorney for Columbia Foundation, a California nonprofit corporation organized and operating exclusively for charitable purposes and which is engaged in rendering financial support to charitable projects, particularly in northern California. Columbia Foundation owns an office building in San Francisco and has no leases which would be characterized as long-term leases under present Internal Revenue Code provisions. On behalf of Columbia Foundation I respectfully urge and strongly support the adoption of amendment to section 514 (b) (2) (A) of H. R. 8300 as recommended by Hon. James P. Kem on behalf of field foundation in testimony before your committee on April 9, 1954. I believe such

amendment is entirely within spirit of legislation taxing rents from supplement U leases and that adoption is necessary in order to remove uncertainties in existing law which threaten charitable organizations with income tax on income never intended to be taxed by Congress.

WILLARD L. ELLIS.

NORTH CHICAGO, ILL., *April 23, 1954.*

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.:

It is my privilege to cooperate as a businessman with the Ways and Means Committee in a very small way on H. R. 8300. In my humble opinion, I think it is the most constructive bill that has ever come out of the Ways and Means Committee for many years. There are some provisions which perhaps need correction and which over a period of time no doubt will be corrected. However, there are so many things about it which are constructive both from the standpoint of the individual as well as the standpoint of the manufacturer and of business that I want to go on record with you and other members of the Senate Finance Committee that this bill be passed with certain constructive changes if possible, but if not possible that it be passed as is. I think one of the most constructive provisions is the recognition that this entity we call a corporation is the most efficient and vital instrument for the collection of taxes that the Federal Government has. The corporation today is not only paying 52 percent of its earnings but actually it is paying the withholding tax and all of the social-security tax and unemployment compensation because in all wage adjustments all employees think not about their gross earnings before deductions for the Government but their take-home pay during the preceding years with corporation taxes as high as they have been the Government has encouraged department financing.

I think the record will show that 85 percent of the new financing has been done by the issuance of bonds or debentures. Surely you will agree that you would not mortgage or place in financial jeopardy that which is vital to the fiscal stability of any organization and certainly much less the United States Government. The modest credit which the investor, not the corporation, will receive, as proposed in H. R. 8300 is recognition of the fact that the Government favors equity financing. It has been my privilege to appear before the Senate Finance Committee and the Ways and Means Committee on several occasions. I was invited to appear this time both by the Illinois State Chamber of Commerce and the National Council of State Chambers, but realizing that you are under pressure as all of us are at this time, it seemed to me that you and the other members of the committee could get my simple honest opinion just as easily by a personal wire. The purpose of this wire is to present to you simply and forthrightly the basic fact that the time has come when investors in corporations should be encouraged to take an equity position rather than that of a creditor. I won't attempt in this brief note to go into any statistics or other details but simply leave the thought with you that because of the vital part that the corporation performs in our economic system as well as in financing the Government, I again urge you to keep in H. R. 8300 the present proposal for credit to the individual on a dividend he has received because of an investment he has made in the most important and practical form of business relationships which we have in our economic system. Thanks for reading this.

Yours sincerely,

JAMES F. STILES, Jr.,
Chairman of the Board and Treasurer, Abbott Laboratories; Past President, Illinois State Chamber of Commerce.

THE NATIONAL FEDERATION OF THE BLIND,
Washington, D. C., April 27, 1954.

Senator EUGENE D. MILLIKIN,
Senate Office Building,
Washington 25, D. C.

DEAR SENATOR MILLIKIN: A recommendation was placed before the Senate Finance Committee during the hearings on H. R. 8300 recently held, that the additional exemption for blind taxpayers, provided for some years ago by Congress, be extended to include blind dependents of taxpayers. The National Federation of the Blind heartily endorses and supports the recommendation and earnestly hopes that the Finance Committee will give favorable consideration to it now.

The special costs of normal living which are consequent to blindness constituted the reasons for granting an additional exemption to blind taxpayers in respect to the income tax. These additional expenses exist no less for blind dependents than for blind taxpayers. The present requirement that taxpayers having blind dependents may take only the usual dependent exemption when paying their income taxes imposes fully as much inequity upon the blind dependent as the lack of the additional exemption imposed upon the blind taxpayer.

Studies carried out by both public and private agencies serving the blind have shown that the special costs attendant upon blindness are as much as 20 to 25 percent in excess of customary costs for nonblind persons. In contrast with the low cost of pencils, the price of a Braille writer for the blind schoolchild or college student is $70 to $100. In contrast with the reasonableness of fountain pens, the price to the same persons of typewriters is considerably in excess of $100. Reader service, whether in school, in business, in professional activity, in homemaking or merely keeping up with world events, is a substantial special cost of blindness. Taxis must be used in many situations where others would walk. Guide service is a frequent expense.

The foregoing are but a few examples of the special money burdens which are borne by blind persons in all ages and in all walks of life. At a glance, it is evident that they exist as much for a blind dependent as a blind taxpayer.

We earnestly request and urge, therefore, that part V, section 151 (d) (1) be amended to read:

"(1) For taxpayer.—An additional exemption of $600 for the taxpayer if he or a dependent is blind at the close of his taxable year."

The blind people of the Nation are deeply appreciative of the consideration and understanding which have been shown to them by the members of the Senate Finance Committee. We believe that our request is just and timely. Our deepest thanks will be yours for calling to the attention of the committee the amendment proposed above.

Sincerely and respectfully yours,

A. L. ARCHIBALD,
Executive Director.

PUBLIC SERVICE CO. OF NEW HAMPSHIRE,
Manchester, N. H., April 22, 1954.

Hon. ROBERT W. UPTON,
Senate Office Building,
Washington, D. C.

DEAR SENATOR: I would like to put before you certain facts with respect to section 309 of the proposed Internal Revenue Code of 1954 (H. R. 8300) and the possible effects of that section on a program which we have initiated of redeeming an outstanding issue of high dividend rate preferred stock.

I have heard it said, among other things, that one of the purposes of section 309 is to levy a tax on corporate reorganizations involving preferred stocks upon which past due dividends are in arrears to a substantial extent. In the face of this, it is unfortunate that the language of section 309 is drawn in such a manner as to catch our company where the preferred stock which we propose to redeem is fully paid and dividends are current.

If, as it appears, the purpose is to plug some loopholes through which tax evasions have seeped in the past, I can assure you there is no tax evasion implied or intended or in any way involved in our case, yet we would be caught in the language of the section. In addition to this, the proposed tax, if adopted, may well force an abandonment of our refunding plans. Should this take place because of section 309, the ultimate and long-time burden bearers will be the consumers who buy the electricity which we supply.

In these circumstances and as applied to our situation, there can be no doubt that the tax would be punitive, discriminatory, and unfair and, therefore, adverse to the interest of the company, its stockholders, and its customers. The events which produce our exposure to the penalties of section 309 are as follows:

Two years ago we needed new money to pay for enlargement of facilities built and building to take care of growing customer demands for electricity. With the sanction of the Securities and Exchange Commission and the New Hampshire Public Utilities Commission we offered 50,000 shares of preferred stock to underwriters at competitive bidding for resale to the public. We received only 1 bid which carried a dividend rate of 5.65 percent.

Naturally this bid was deemed unsatisfactory and, therefore, was rejected. After rejection, permission was obtained from both the SEC and New Hampshire Public Utilities Commission to negotiate a deal with underwriters. This resulted in the resale of the 50,000 shares of 5.40 percent preferred stock to the public at $102.85. In accordance with usual procedure, the initial redemption price was set at $105.85 which is only 3 points above the price paid by the public but which, unfortunately, is more than 5 percent above the $100.20 net per share received by the company. Because of this, the refunding, as we understand it, would be taxed under section 309 at the rate of 85 percent of $0.64 per share which is the amount by which the redemption price of $105.85 exceeds 105 percent of $100.20 ($105.21). To this amount of tax would be added 85 percent of the amount of dividends accrued at the redemption date.

Depending upon timing, which to a substantial extent is out of our control, the minimum tax would be $27,200 and the maximum, $84,575. This exposure is a sufficient threat to cause us to reconsider the whole program.

The reason our redemption price is more than 5 percent above the net amount of $100.20 realized is because our company was having credit difficulties at the time the 5.40 percent stock was marketed. After the failure of competitive bidding, a negotiated deal was possible only after accepting an underwriter's spread of $2.65 per share. This high spread when added to the net amount realized by the company of $100.20 and the initial 3-point redemption figure produced automatically the $105.85 redemption price.

It seems unnecessary, illogical, unfair, and discriminatory for this company to be taxed out of the benefits to company, stockholders, and consumers of a straightforward redemption and refunding operation now that improved credit makes such a thing possible. It seems almost certain that we can market a preferred stock today at a dividend rate substantially less than 5.40 percent. However, to redeem the present 5.40 percent stock, we shall have to pay costs aggregating approximately $265,000. If on top of this we have to pay taxes which might be as high as $84,525, the whole deal probably would be called off because of the increased expense. This possibility I submit is an unjust, unreasonable, and unwarranted discrimination against our company, its stockholders, and the 70 percent or more of the people of New Hampshire which make use of the company's electricity.

Anything you can do to eliminate this threat will be much appreciated, particularly in view of the fact that we are now in the process of asking our stockholders to take action on matters related to the redemption of the 5.40 percent preferred at the annual meeting on May 13, 1954. This action was started before we heard of the threat of section 309, but it cannot be consummated until after the annual meeting on May 13.

With best wishes, I am,

Sincerely yours,

A. R. SCHILLER, *President.*

ERNST & ERNST,
Cleveland, April 20, 1954.

Re H. R. 8300.

Mrs. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, 25, D. C.

DEAR MADAM: We respectfully request that you bring to the attention of the Senate Finance Committee, our views with respect to section 736, H. R. 8300, payment to a retiring partner or a deceased partner's successor in interest.

This section provides that payments made within 5 years after the partner's retirement or death shall be taxed to the recipient and that payments made after 5 years shall be taxed to the remaining partners and excluded from the gross income of the recipient. Such later payments, according to the report of the Committee on Ways and Means (p. A 230) "shall, in effect, be treated as a distribution to the remaining partners and as a gift of such amounts to the recipient."

On its face, it would appear grossly inequitable to impose a tax upon a group of partners with respect to income which they cannot receive and to exempt such income from taxation in the hands of the recipient.

It has been suggested that the inequities of the proposed law may be avoided by simple amendment to partnership contracts so as to continue in effect the

partnership interest on a nominal basis. If that is true, then the proposed law certainly will not accomplish what its drafters intended.

We wish to point out, however, the serious inconvenience which these provisions would bring to a firm such as ours if we were compelled to amend our partnership agreement to avoid the inequities inherent in the proposed shifting of income tax liability.

At present our firm has 80 partners. We operate 62 offices throughout the United States and Canada.

All of our partners are required to be certified public accountants and in many States, we cannot operate as certified public accountants unless all of our partners hold certified public accountant certificates in such States. Many States require annual registration of certified public accountants and failure to register may involve loss of privileges.

Many States have statutes under which partnerships must register whenever changes occur in membership, such registration frequently requiring personal signatures and jurats as well as newspaper publication.

In order to avoid the substantial inconvenience of depending upon inactive and retired partners to maintain their status as certified public accountants in each State where the firm business is conducted and to obtain necessary signatures and formal acknowledgments for numerous reports and filings required at frequent intervals, we have arranged for retired partners to withdraw from membership in the firm. Notwithstanding such withdrawal, a limited participation in income is provided for the retired partner so long as he lives.

If we now must reinstate retired partners to membership in order to avoid the inequity of having their income (after 5 years) taxed to successor or continuing partners, we are then faced with all of the inconveniences which withdrawal from membership was designed to obviate.

We recognize no justification for taxing one partner upon the income which is payable to another, irrespective of the duration of the period of payment. Such continuing income is not unlike pension payments made to retired employees. It is the partnership method of making possible the retirement of partners upon reaching advanced age.

We respectfully ask that you give consideration to this section of H. R. 8300 in order that the inequity inherent therein may be removed. A partner should be taxable only upon income accruing to him. This principle should be applicable to the period before retirement as well as for any period of participation thereafter.

Respectfully submitted.

L. C. WEISS, *Resident Partner.*

STATEMENT OF THE NATIONAL COUNCIL OF SALESMEN'S ORGANIZATIONS, INC.,
New York 18, N. Y., April 23, 1954.

STATEMENT OF THE NATIONAL COUNCIL OF SALESMEN'S ORGANIZATIONS, INC., RESPECTFULLY SUBMITTED TO THE SENATE FINANCE COMMITTEE OF THE 83D CONGRESS, 2D SESSION, WASHINGTON, D. C.

TOPIC—BUSINESS EXPENSE DEDUCTIONS FOR AND FROM ADJUSTED GROSS INCOME FOR OUTSIDE SALESMEN, SECTIONS 62 (2) (C) AND 62 (2) (D)

The National Council of Salesmen's Organizations, Inc., hereinafter referred to as national council, is a nonprofit membership corporation, duly organized under the laws of the State of New York with its principal office at 80 West 40th Street, New York, N. Y.

National council is the parent body of wholesale salesmen's industry and trade groups, associations and clubs, whose individual members are outside wholesale salesmen, i. e.; they sell the goods, wares, and merchandise of American factories to retailers and other distributors for resale to the consumer. Appended hereto is a list of the council's members and affiliated groups.

As the national voice of these salesmen's groups representing a wide range of industries including furniture, toys, paints, apparel trades, drugs, textiles, and many others, it is a genuine privilege for national council to appear before this honorable and most important committee of our Congress to present briefly its recommendations with respect to topic 6, particularly as they affect the economic welfare and well-being of the estimated 1,350,000 or more outside salesmen and their families.

This memorandum is respectfully submitted to your honorable committee in support of the proposed amendment to section 22 (n) of the Internal Revenue Code, which was recommended by the Committee on Ways and Means and embodied in H. R. 8300 passed by the House of Representatives (secs. 62 (2) (C) and 62 (2) (D)).

As indicated in the report of the Committee on Ways and Means dated March 9, 1954, accompanying H. R. 8300 (p. 9 thereof), these amendments correct an inequitable tax situation in relation to the transportation and business expenses of outside salesmen.

The following excerpts from the statement of the National Council of Salesmen's Organizations, Inc., dated June 19, 1953, submitted to the House Ways and Means Committee, illustrate the inequities which the amendments could correct.

We earnestly recommend approval of these specific amendments by the Senate Finance Committee in its deliberations on the omnibus tax bill now before it.

1. Elimination of the divergent tax liabilities in certain instances between the "traveling" and the "city" salesman.

Section 22 (n) of the code presently permits an employee to deduct, in determining gross income, his expenses of travel, meals, and lodging "while away from home" but no other expenses except those for which he is reimbursed by his employer.

The limiting clause "while away from home" creates certain anomalous situations wherein a city salesman and a traveling salesman with the same income and the same expenses, and otherwise in the identical position taxwise will have varying tax liabilities, while the city salesman pays a greater tax on the same income: The following illustration will graphically indicate the unfairness of the present law in this respect.

In the example given below, Salesmen A and B are both employed by the same corporation, earn $10,000 each in salaries and commissions. A travels outside the city. B's territory is within the city and its environs. Both are married. Their respective wives have no independent income and they have no dependents. A and B both use their individually owned cars in their selling activity and are not reimbursed by their employer. Each has $1,000 auto expenses in the tax period and each has total deductions of $200 for taxis, contributions, charities, etc. This is their comparative tax computations on the basis of joint returns:

	A (traveling)	B (city)
Gross earnings	$10,000 00	$10,000.00
Traveling expenses away from home	1,000 00	None
Adjusted gross income	9,000 00	10,000 00
Standard deduction	900.00	None
Itemized expenses.		
Car expense	None	1,000.00
Other expense	None	200 00
Net income	8,100 00	8,800.00
Exemptions	1,200 00	1,200 00
Normal tax and surtax, net income	6,900 00	7,600.00
Tax due	1,601.40	1,777.60

As we understand it, it is the purpose of this committee to overhaul the Federal tax structure so as to bring it up to date with changed industrial and economic conditions. The example given by us, then, is a case directly in point. New methods of distribution on the part of industry have severely curtailed and restricted salesmen's territories. Suburban consumer areas have shown phenomenal growth. The salesman, who is assigned to city and neighboring territories without being "away from home," should be under no greater tax disadvantage with respect to expenses of his automobile, for example, which is an equal necessity to him, than the traveling man. We believe this situation should be corrected by the elimination of the restricting clause in section 22 (n) "while away from home" which, incidentally, is a most contentious one at best.

The illustration we have given deals with expenses of upkeep of an automobile. It is intended only to demonstrate the general inequity of the restrictive clause,

"while away from home." There are other deductible expenses which an employee salesman must inevitably incur in a highly competitive economic field in order to effectively and successfully sell his employer's goods.

Let us examine the matter of entertainment or of advertising expenses. Reasonable expenses of entertaining buyers are deductible as a legitimate business expense by employers. Why should the employee salesman, who may be under similar expense, not be permitted to deduct his reasonable expenses of entertainment in determining adjusted gross income in such cases where he is not reimbursed by the employer? Another example of the discriminating effect of the present tax requirements is in the matter of advertising. Certainly, the employer is allowed the reasonable expenses of promoting his product. In such instances where an employee salesman should, for example, send out a personal reminder or other mailing piece to his customers, he is not allowed to deduct such expense in arriving at his adjusted gross income. These inequities should be corrected by your committee in recommending a new tax bill. Your committee will remember, we are confident, that such salesmen, in particular, who must look entirely to their commission earnings for meeting both the costs of selling, such as travel, hotel, meals, goodwill, etc., and also their costs of living and that of their families, are in an economic vise. Their lot should not be made more difficult by discriminatory and unfair tax liability requirements such as we have endeavored to illustrate.

2. The present tax law which prohibits an employee from deducting for adjusted gross income purposes no more than the actual amount he may be reimbursed should be corrected.

Under the current law if an employer pays a salesman an expense account, or otherwise reimburses him for expenses other than expenses of travel, meals, and lodging while away from home overnight, the employee salesman adds these reimbursed amounts to his gross income and then is permitted to subtract the amount he is reimbursed, but cannot deduct more than that. Any excess which he may have to pay out of his own pocket, without reimbursement, is relegated to an expense item under "Miscellaneous" on page 3 of form 1040.

Again we submit that the conditions of selling have changed radically so as to make this rule archaic and obsolete. The expenses of selling for the salesman today have risen far beyond any amount for which he may be reimbursed by even the most progressive employer. Why should the salesman be restricted in this manner when there is no such comparable restriction on his employer, or principal, when he calculates and determines his net income?

The salesman who must dig into his own purse to pay expenses, which can be substantial, and are directly connected with his costs of selling his products, should in all fairness and equity be permitted to treat his legitimate expenses of carrying on his trade or profession, if you will, of selling, in the same manner as is an independent businessman who is allowed to deduct his expenses of doing business without restriction as to amount.

We, therefore, respectfully submit consideration by your committee to the elimination of this restrictive limitation on such salesmen who may be reimbursed in part for their expenses by lifting the present requirement which limits them in such cases only to an equal offset of expenses against the reimbursement in determining adjusted gross income.

Respectfully submitted

LOUIS A. CAPALDO,
President.
BENJAMIN SHAPIRO,
Chairman, Legislative Action Committee,
National Council of Salesmen's Organizations, Inc., 80 West 40th Street, New York, N. Y.

MITCHELL M. SHIPMAN, Esq.,
General Counsel, 149 Broadway, New York 6, N. Y.
SANFORD GREEN, Esq.,
Of Counsel.

ASSOCIATIONS AFFILIATED TO AND COOPERATING WITH THE NATIONAL COUNCIL OF SALESMEN'S ORGANIZATIONS, INC.

Allied Textile Association
Amigos of Syracuse, Inc.
Associated Millinery Men of New York
Associated Millinery Men of Philadelphia
Boot & Shoe Travelers Association of New York, Inc.
Boys Apparel Salesmen's Club
Central States Hardware Club
Connecticut Paint Salesmen's Club, Inc.
Costume Jewelry Salesmen's Association, Inc.
Dress Salesmen's Association
Drug Salesmen's Association of Pennsylvania, Inc.
Empire State Furniture Manufacturers' Representatives, Inc.
Fabric Salesmen's Guild of New York
Fabric Salesmen's Association of Boston, Inc.
Fabric Salesmen's Club of Chicago
Food Products Salesmen's Association, Inc.
Furniture Manufacturers' Representatives of New York, Inc.
Furniture Manufacturers' Representatives of New Jersey, Inc.
Garment Salesmen's Guild
Handbag Supply Salesmen's Association, Inc.
Infants & Children's Wear Salesmen's Guild, Inc.
Infants' Furniture Representatives Association of Greater New York
Luggage & Leather Goods Salesmen's Association of America, Inc.
Manufacturers' Representatives Association of Sporting Goods
Maryland Wholesale Furniture Salesmen's Association
Men's Apparel Guild of Wholesale Salesmen
Men's Apparel Club of New York City, Inc.
National Handbag & Accessories Salesmen's Association, Inc.
New England Corset & Brassiere Club
New England Negligee & Lingerie Association
New York Association of Hosiery Mill Salesmen
New York Candy Club
New York Corset Club
New York Paint Travelers, Inc.
New Jersey Paint Travelers Association
New York-Pennsylvania-Ohio Travelers Association, Inc.
Philadelphia Corset & Brassiere Club
Philadelphia Cosmetic Club
Philadelphia Manufacturers' Representatives Association
Philadelphia Textile Salesmen's Association
Philadelphia Wholesale Furniture Salesmen's Association
Philadelphia Save-the-Surface Paint Club
Professional Sales Club of New York
St. Louis Textile Club, Inc.
Sportswear Salesmen's Association, Inc.
Textile Veterans Association
The Salesmen's Association of the American Chemical Industry
Rocky Mountain Trade Association
Southern Travelers' Association, Inc.
The Far Western Travelers' Association, Inc.
The Piece Goods Salesmen's Association, Inc.
Toy Knights of America
Underwear-Negligee Associates, Inc.
Wash Frock Salesmen's Association, Inc.

C. RIGDON ROBB & ASSOCIATES,
Chicago 4, April 27, 1954.

Re H. R. 8300, employee trust provisions

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: As employee benefit plan consultants, we represent approximately 50 companies in the Chicago area who have approved pension or profit-sharing

plans. Many of these have been installed for several years and all have qualified under present section 165 (a) of the Internal Revenue Code. We remember vividly 1942, when this section was revised and the subsequent long wait that occurred before regulations were issued. During this time, employers faced a great period of uncertainty in adopting plans and much confusion resulted therefrom. One thing that disturbs us in the present revision of this section 165 and related sections is the fact that it is being completely rewritten and that in the haste to do so many points will not be clarified and that we again will have a long wait for clarifying regulations.

While we appreciate the desirability of the recodification and the placing of the sections under appropriate headings, we cannot understand why it was necessary to change completely certain fundamental sections of the code, relating to pension and profit-sharing plans.

The thing that mostly concerns is the attempt to substitute inflexible rules for some measure of judgment on the part of the Bureau representatives. It has been our experience that in the interpretation of the present regulations which have been supplemented by a long list of rulings, discrimination and unfair practices have been eliminated and that the Bureau on the whole has been extremely fair-minded in protecting the interest of the tax collector, and at the same time recognizing the problems of the employer and taxpayer. In such a complex subject as employee-employer relations, it seems to us rather difficult to lay down hard-and-fast ironclad rules to eliminate entirely the judgment of trained capable revenue men.

Another alarming thought is the possibility that present plans which are well qualified may have to be amended at some future date, and that then they would have to qualify under the new law, which might place many of them in the position of having to greatly modify their plans in order to qualify under the proposed regulations. We appreciate that the intent is to liberalize these provisions, but in applying some of the principles to existing plans, we find that such so-called liberalization becomes unduly restrictive in many deserving cases and really opens the gates to tax avoidance in other less deserving situations. Specifically, we would like to call attention to the following items as one which need more careful thought before they are incorporated in the final version of the bill:

Attention is called, first of all, to section 501 (e) (3) (A), subheading, "Nondiscriminatory classifications." Particular reference is made to portions of subparagraph (A), reading as follows:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification—"

In placing of this language we would urge that something like the following be substituted:

"Discrimination in favor of employees who are shareholders or key employees shall not be determined by any fixed percentage of contributions or benefits, or both, or by any limitation upon the number or classification of participating employees. A plan—"

A provision of this nature is not mechanical, specifically grants power to the Commissioner of Internal Revenue to approve or disapprove plans, but prohibits the use of any fixed percentages in determining whether or not discrimination exists. It will give the Commissioner the power he has thought necessary since his 30-percent regulation was withdrawn, and will permit proper consideration of each plan on its own merits. Subject to some general rules, individual consideration is the only fair method of determining whether or not a stock bonus, pension or profit-sharing plan is discriminatory. In this matter we are following the recommendations made by the written statement of Bert C. Bentley as of April 14. In Mr. Bentley's presentation he substantiates by examples the objections we have to this portion of the bill.

Section 501 (e) contains 1 final sentence which deals with 3 completely unrelated matters. First, and most important, it apparently eliminates the provision in the present code that contributions be accorded to a predetermined formula in a profit-sharing plan. Inasmuch as these plans are instituted primarily as a substitute for pensions plans, it seems quite probable that the elimination of this requirement and the substitution of a hit-or-miss contribution schedule by the employer, regardless of profits, would lead to some very discriminatory practices.

It seems unwise, in view of all the restrictions along this line that have been incorporated in approved plans in the past, that this field should be opened up to discrimination on the part of an employer, particularly at a time when labor relations are as touch-and-go as they are at this time. Furthermore, this provision can be construed as permitting plans in which only one contribution is ever made, which could certainly lead to a tax avoidance in the year in which the Government really needed money, and yet would accomplish very little as far as employees are concerned. The other two provisions in this sentence are not necessarily objectionable but seem to be so worded that there might be some ambiguity.

Subsection 402 (a) (4), which changes the present law with respect to the taxability of premiums paid for life insurance by a qualified trust, seems an unnecessary change and an undue penalty on the beneficiary. It has been a well conceived principle of tax law for many years that life-insurance proceeds are not subject to income tax. For this reason there has been no great disagreement with the collection of a tax on the cost of the insurance currently. It seems far better to leave the law as it stands and collect this tax currently from the employee while he is living rather than to impose this additional income-tax burden on his beneficiary. Section 505, dealing with allowable investments for employees' trusts, seems to have been lifted pretty largely from the supplement Q, subsections 361 and 362 of the present law, which deals with the tax status of regulated investment companies. Although undoubtedly well intentioned, the new section produces some inconsistent unfortunate results when applied to employees' trusts, which have a totally different purpose than investment companies. For one thing, we cannot understand the fact that ordinary life policies and a supplementary fund which have been used in many plans, are omitted from qualified investments. Furthermore, it seems unwise to relax the present rule which vests some discretion in the Internal Revenue Service, as to the investment of all the money in an employees' trust in securities of the employer. While this would serve the purpose of furnishing additional capital tax free for many employers, that does not seem to be the intent of allowing a deduction for contributions to an employees' trust. Many small close corporations, whose stock is not readily marketable and whose success depends on the efforts of 1 or 2 men, could well have a value of appreciably less than had been anticipated by the employees, particularly if 1 or 2 of these keymen were to die and no provisions had been made for continuing the business. Furthermore, many of these stocks of closely held corporations have not and do not intend to pay any dividends. Therefore, they certainly are not good investments for trust assets. It seems to us that these trusts must be considered as real trusts and that the prudent-man rule incorporated in so many State laws dealing with investment of trusts should be the very minimum that would be required of trustees investing funds for the benefit of employees.

It would seem that this whole section should be reexamined in the light of the realities of the situation and that there not be an attempt to lift bodily language from other sections that do not necessarily apply in their entirety to the subject under consideration.

With most of the other provisions, we can find faults in language but on the whole we want to commend the Congress for their forthright action in attempting to remove many of the inequities and much of the doubletalk now appearing in the present regulations. We ,therefore, hope that this whole subject will be reexamined with a view to keeping it consistent with past practice and to square up with the realities of the situation.

Respectfully submitted.

C. RIGDON ROBB.

PORT OF SEATTLE,
Seattle 11, Wash., April 21, 1954.

The Honorable EUGENE MILLIKIN,
United States Senator for Colorado,
Senate Office Building, Washington, D. C.

DEAR SIR: I am addressing through you as chairman, the United States Senate Finance Committee, requesting their consideration of the effect that section 274 of H. R. 8300, if made law, will have on the future development of the Pacific Northwest, specifically Seattle and King County, State of Washington.

The undersigned, president of the Port of Seattle Commission, a municipal corporation under the laws of the State of Washington, was directed by the

commission to take such steps as necessary to inform the Washington State congressional group and others in the Congress of the United States that the provisions of section 274 of H. R. 8300, if made law, will do grievous injury to the future growth and economic prosperity of our area.

Attached herewith is a legalistic approach to this matter as prepared by Mr. Tom Alderson, of the law firm of Bogle, Bogle & Gates, attorneys for the port of Seattle. I respectfully call this to the attention of the committee. However, I wish to stress the human values involved.

Ours is a rapidly growing community. By 1970 we estimate, conservatively, over 1 million people will be living in Seattle. The question as to how we are to provide the necessary livelihood for these citizens has become an important consideration of responsible people. The commissioners of the port of Seattle, elected officials, consider themselves partly responsible. Together with the county commissioners, city council, the mayor of Seattle, and some eminent private citizens, and supported by the press, we have an industrial committee working on the common problem of providing industrial sites for the factories, etc., that must provide employment for these newcomers.

One real potential site area is what we call the Duwamish River project, where at the present moment the above three political agencies are having an engineering study made by one of the leading engineering firms of our Nation at an initial cost of $45,000. As a result of this survey it is planned that the Port of Seattle Commission will spend several millions of dollars secured by the sale of general obligation bonds to buy up the land and prepare industrial sites.

When these sites are prepared the Port of Seattle Commission representing the public, will be prepared to offer deepwater sites to manufacturers desiring such a location. Inquiries for such sites are repeatedly received in Seattle, particularly from concerns wishing to utilize waterborne shipping in order to get their product to foreign and domestic markets. Some of these firms may require financial aid which the port was prepared to provide by the sale of revenue bonds, the lessee amortizing same by his rental payments.

Enactment of section 274 will render this impossible, thereby denying Seattle and other western communities the possibility of providing employment for the great numbers moving into our area.

No matter what definitions are written in, we feel that the proposed section will greatly jeopardize the orderly growth of the Pacific Northwest and urgently recommend that section 274 be struck out of H. R. 8300.

Respectfully yours,

GORDON ROWE,
Rear Admiral, USN (Retired), President, Port of Seattle Commission.

THE DOCTRINE THAT MUNICIPAL BONDS ARE EXEMPT FROM FEDERAL TAXATION: ITS HISTORY AND PRESENT CONDITION

INTRODUCTORY

The question whether the income from revenue bonds or other types of securities issued by municipal airport operators is subject to Federal income tax, may seem to be one of interest only to constitutional lawyers; but on the contrary, this matter of law has a strong and direct practical effect on airport operations.

To keep up with the demands of the general public for air transportation, and to keep up with the needs of the airlines which provide air transportation, municipal airports have been and will be under great pressure to expand their facilities. Airports must build and improve their runways, lighting systems, hangars, terminal and air cargo buildings, repair shops and airline overhaul bases.

In the recent past, this construction has been financed in various ways. Money has been raised either by a direct use of taxes or by the issue of general obligation bonds upon the security of taxes. Municipal airports have also received a great deal of financial aid from the Federal Government.

Before now, not much use has been made of revenue bonds, because investors have not been willing to buy them. Airport operations are now sufficiently well established for airport authorities to consider revenue bonds as a source of capital, especially where their proceeds are to be devoted to building facilities which can be leased to commercial airlines for long terms.

The availability of capital through issue of bonds has suddenly become far more important than in the recent past, because the Federal Government is sharply reducing the amounts of aid which it will give.

It is obviously vital to airport authorities that in borrowing large amounts of capital, they should get the lowest possible rates of interest. Differences of less than 1 percent in the cost of borrowing capital, may be the difference between profit and loss in airport operations, or at least may determine whether a particular project will pay for itself or not.

At the present time, municipal corporations—airport authorities are usually municipal corporations—are able to borrow money on terms equal to or slightly better than those available to private corporations, largely for one reason. This reason is that the interest paid on municipal bonds is not subject to Federal income tax. Any individual or institutional investor which pays income taxes at high rates, is willing to accept interest at low rates on his investment if that interest is tax free.

So much for introduction. We have a tax exemption. We have a borrowing advantage. The main point of these remarks is that if we do not look out we may lose both the exemption and the advantage. Therefore, all of us must assemble economic data showing first, the benefits which result from their operations to the communities which they serve and to the general public; second, the extent to which these benefits depend upon being able to borrow money at low rates; and third, the harm which would be done to their operations if they were required to compete for capital on an equal footing with other borrowers.

HISTORICAL REVIEW

In order that the danger of losing the benefit of tax exemption may be fully understood and appreciated, one must go back a little bit into history and review the development of intergovernmental tax immunity. This is the idea that States cannot tax the securities of the Federal Government and that the Federal Government cannot tax the securities of State Governments.

This idea originated in 1819, in the famous case of *McCulloch* v. *Maryland*[1] in which the United States Supreme Court decided that the Maryland State Legislature could not lay a heavy tax on the Second Bank of the United States, a Federal Government corporation. The Court said:

"* * * the power to tax involves the power to destroy; * * * If the States may tax one instrument, employed by the Government in the execution of its powers, they may tax any and every other instrument. They may tax the mail; they may tax the mint; they may tax patent rights; they may tax the papers of the customhouse; they may tax judicial process; they may tax all the means employed by the Government, to an excess which would defeat all the ends of Government. This was not intended by the American people."[2]

The reasoning of the Court was that in our Federal system with State government and Federal Government side by side, it is essential that each in its proper sphere be protected against encroachment by the other. Regarding taxes, the Court emphasized that a tax could not be considered legal or illegal depending on whether it was light or heavy or good or bad in its effect; for the imposition of even a light tax would imply to realistic men that on successive later occasions, heavier and heavier taxes might be imposed. The Court also pointed out the practical difficulty of distinguishing between reasonable and unreasonable taxes, if reasonableness were to be made the test.

By the time of the Civil War, the Supreme Court had followed up *McCulloch* v. *Maryland* with several other cases holding that various taxes imposed by States upon money borrowed or persons employed by the United States, could not be permitted because they were potentially destructive restraints on Federal activities.[3]

The first Federal income tax was enacted about the time of the Civil War, and it caused the problem to rise the other way: Could the Federal Government tax State instrumentalities or activities? The answer was "No," because tax immunity worked both ways. The Supreme Court, therefore, decided that the judge of a State court did not have to pay Federal income tax.[4]

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[1] 4 Wheat. 316, 4 L Ed. 579 (1819)

[2] 4 Wheat. at 431, 432, 4 L Ed. at 607, 608.

[3] *Osborn* v *Bank of the United States* (9 Wheat. 738, 6 L. Ed. 204 (1824)), Ohio tax upon Bank of United States unconstitutional; *Weston* v. *City Council of Charleston* (2 Pet. 449, 7 L. Ed. 481 (1829)), South Carolina intangible property tax unconstitutional when applied to United States Government securities; *Dobbins* v. *Commissioners of Erie County* (16 Pet. 435, 10 L. Ed. 1022 (1842)), Pennsylvania occupations tax unconstitutional when applied to salary of captain of United States revenue cutter

[4] *Collector of Internal Revenue* v *Day* (11 Wall. 113, 20 L. Ed. 122 (1871)).

Down toward the end of the century, the Court finally came out with the proposition that we are now concerned with, deciding in *Pollock* v. *Farmer's Loan & Trust Co.*[5] that Federal income tax could not be collected on the interest paid on municipal bonds.

The reasoning of the Court here was that a tax upon such interest was, in effect, a tax upon the power of States and their political subdivisions to borrow money. Here again, it made no difference that the burden resulting in a particular case might be small, in view of the possibility that a crushing burden might be imposed on some other occasion.

This Pollock case also decided, believe it or not, that any Federal income tax was unconstitutional.[6] In this respect, of course, the Constitution was amended in 1913 by the 16th amendment, which authorized a Federal tax to be placed on incomes, "from whatever source derived." The inclusion in the amendment of these four words, "from whatever source derived," suggested anew the possibility that the Federal Government had the power to tax State or local officials or activities; but the Supreme Court has disclaimed the view that the amendment extended the power of Congress to tax incomes not taxable before.[7]

During the 19th century, therefore, the Supreme Court worked out the principle that under the Federal Constitution, State governments may not tax Federal Government bonds, Federal corporations, or Federal employees. Likewise, as a matter of reciprocity, the Federal Government may not tax State or local government bonds or employees.

RECENT DECISIONS OF THE COURT

The Pollock case[8] is still the law. Under the Pollock case the Federal Government may not tax municipal bonds, but in constitutional law as in all branches of the law, judicial opinion is permitted to change, and it does change. In recent years, there have been several decisions of the Supreme Court on related questions in the field of intergovernmental tax immunity; and these decisions indicate that if the question, whether State or municipal securities may constitutionally be taxed, should now or in the future be presented again to the Supreme Court, the Pollock case might be overruled.

One of the straws in the wind is the matter of the taxing of salaries of Government employees.

Two decisions of the Supreme Court, in 1938 and 1939, held respectively that Congress might tax the salary of employees of the Port of New York Authority,[9] and that New York State might tax the salary of a Federal employee.[10] The Civil War case of the State judge who did not have to pay Federal income tax,[11] was expressly overruled.

Although the recent decisions do not say that the Federal Government can tax State or municipal bonds, they come close to it.

CURRENT LEGISLATIVE PROPOSALS

If, then, the question of taxing income from the municipal securities should be presented afresh to the Supreme Court, it might be decided differently. Can the question be presented to the Court? At the present time, the answer is "No." Ever since the enactment of an income tax law in the wake of the 16th amendment, the tax law itself has exempted the income of municipal securities from taxation.[12] This, too, however, is a situation which may change.

On numerous occasions during the last 20 years, proposals have been made in the Congress to remove the exemption. In 1939 the Ways and Means Committee of the House of Representatives had extensive hearings on the subject of the

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[5] 157 U. S. 429, 15 S. Ct. 673, 39 L. Ed. 759 (1895).

[6] Opinion on rehearing. 158 U. S. 601, 15 S. Ct. 912, 39 L. Ed. 1108 (1895).

[7] *Brushaber* v. *Union Pacific R. Co.* (240 U. S. 1, 36 S. Ct. 236, 60 L. Ed. 493 (1916)), primary purpose of 16th amendment was to enable Congress to tax incomes without apportionment among the States, irrespective of whether derived from property or from labor.

[8] *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429, 15 S. Ct. 673, 39 L. Ed. 759 (1895)).

[9] *Helvering* v. *Gerhardt* (304 U. S. 405, 58 S. Ct. 969, 82 L. Ed. 1427 (1938)).

[10] *Graves* v. *New York ex rel. O'Keefe* (306 U. S. 466, 59 S. Ct. 595, 83 L. Ed. 927 (1939)).

[11] *Collector of Internal Revenue* v. *Day* (11 Wall. 113, 20 L. Ed. 122 (1871)).

[12] Tariff Act of October 3, 1913, c. 16, sec. II B, 38 Stat. 167. The law now applicable is Internal Revenue Code (Revenue Act of 1938, as amended, sec. 22 (b) (4), 26 U. S. C., sec. 22 (b) (4) Similar provisions in force from time to time are listed in 26 U. S. C. A., following sec. 22, Historical note.

exemption both of municipal securities and of salaries paid by municipalities.[13] Out of these hearings came the Public Salary Tax Act of 1939,[14] which removed the exemption as to salaries. This change in the law has been tested in one of the lower Federal courts, and it has been constitutional.[15] The Supreme Court refused to review this decision which apparently settles the question of whether the Federal Government can tax the salaries of State and municipal employees.

In the current session of Congress, the Ways and Means Committee of the House of Representatives, proposed to remove the tax exemption from "interest received from so-called industrial development bonds of State and local Government units." [16] In its statement the committee added,

"These are bonds issued to finance the purchase or improvement of property to be leased to private manufacturing concerns. The denial of exemption does not apply where the governmental unit pledges its full faith or credit, or taxing power, to guarantee the payment of bonds."

Following a multitude of protests from State and local officials, this proposal has been put on the shelf; but in its place now stands a proposal that rent paid by an industrial lessee to the municipality which issues industrial development bonds, shall not be a deductible business expense to the lessee.[17]

This substitute proposal raises separate constitutional issues which there is not time to go into now, but the fact that these proposals have been made, and have been supported by the committee of the House of Representatives wherein tax legislation originates, should be enough to show the danger of the present situation.

The first proposal, now on the shelf, is of course directed only at revenue bonds, which are not backed by the taxing power of the issuing authority. This is no comfort to us, first, because it is generally far more convenient and practical to issue revenue bonds—if there is a market for them—than to issue general obligation bonds; and second, because we have no assurance whatever, except the word of the present chairman of the Ways and Means Committee, that Congress would not in the future, remove the exemption from both general obligation and revenue bonds.

The second proposal, as things now stand, is on the way to become law and it must be resisted with just as much vigor as the first, because its practical effect will be the same. An airline proposing to lease facilities from an airport authority will certainly hesitate long over such an arrangement, and may abandon the project altogether, if it turns out that its rents are not deductible. At the least, the airline will insist upon lower rents. Thus, whereas removing the tax exemption would raise the level of interest expense to the airport authority, disallowance of the rent deduction to the lessee would lower the rent income of the airport authority, so that in either case the net income of the airport authority from that particular operation would be reduced or wiped out.

The second proposal, regarding the deductibility of rents paid to municipalities, has a further vice in that it obviously singles out and discriminates against

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[13] Taxation of Governmental Securities and Salaries; hearings before the Special Committee on Taxation of Governmental Securities and Salaries, United States Senate, 76th Cong., 1st sess., January–February 1939. For other extensive discussions of the subject in the Congress, see Revenue Revision of 1942: hearings before the Committee on Ways and Means, House of Representatives, 77th Cong., 2d sess., March–April 1942, at pp. 8, 64–76, 1479–1610, 3079–3160; Revenue Act of 1942: hearings before the Committee on Finance, United States Senate, 77th Cong., 2d sess., July–August 1942, at pp. 539–673; Revenue Revision of 1951: hearings before the Committee on Ways and Means House of Representatives, 82d Cong., 1st sess., February–March 1951, at pp. 13–14, 88–94, 903–1159. See also Taxation of Governmental Securities and Salaries: Report of the Special Committee on Taxation of Governmental Securities and Salaries and Views of the Minority, pts. 1 and 2, S. Rept 2140, 76th Cong., 3d sess., September 18, 1940.

[14] April 12, 1939, c. 59, 53 Stat. 574; 5 U. S. C., sec. 84a, 26 U. S. C., sec. 22.

[15] *Gunn* v. *Dallman* (171 F. (2d) 36 (C. A. 7th, 1948)), certiorari denied 336 U. S. 937, 69 S Ct. 747, 93 L. Ed 1095 (1949).

[16] Committee announcement, January 20, 1954.

[17] Press release issued by Representative Daniel A. Reed, chairman, House Ways and Means Committee, on February 8, 1954. The release reads in part: "The committee also agreed today to a change in its previously announced proposal to tax the interest on certain municipal industrial development revenue bonds. Instead of taxing the interest, the amendment agreed to today would simply disallow the deduction of amounts, such as rent, paid or accrued by the industrial lessee to the municipality which issues the bonds. This disallowance will only apply in cases where the bonds are revenue bonds and do not carry the full faith and credit of the issuing authority. Today's action will correct the same evil against which the original amendment was directed and will do so more effectively."

municipalities. What sense can there be in allowing an airline to deduct as business expense the cost of renting office space in a privately owned midcity office building, but disallowing the cost of renting hangar space out at the municipal airport?

All in all, both proposals must be viewed with alarm as opening the door to a full-scale attack upon the credit, the borrowing power, and ultimately the independence of State and local government. If the right of State or local government to exercise any governmental or proprietary function is to be questioned, at least the question should be raised in a manner above board and direct, and not through the meandering channels of Federal tax policy.

Prepared on behalf of port of Seattle, by Tom M. Alderson.

BOGLE, BOGLE & GATES, *Counsel.*

PORT OF SEATTLE,
Seattle, Wash., April 21, 1954.

PORT COMMISSIONER VIEWS PROVISION IN NEW TAX LAW EXTREMELY DETRIMENTAL TO GROWTH OF THIS AREA

Commissioner Gordon Rowe, president of the port of Seattle commission, has just returned from attendance at the Airport Operators Council, in Tampa, Fla. In the course of his trip east and he made business calls for the commission in Chicago and New York City. Stopping over in Washington, D. C., he consulted with members of our congressional delegation on a number of matters not only important to the port of Seattle but the area as a whole, Rowe said.

Of vital importance at the present moment is the Senate's action on H. R. 8300, the new tax law which has passed the House of Representatives. In particular, section 274, of that law is of the greatest significance to the future growth of the Pacific Northwest.

Section 274, briefly stated, according to Rowe, will disallow as a business expense deductions from gross income, rental payments made by private manufacturing lessees for property acquired or improved by States and local governments and financed by Government bonds which are not backed by the full faith and credit of the issuing Government. Commissioner Rowe has viewed this legislation from its inception as a dangerous threat to the orderly growth of our area. There are two ways of viewing this matter: First, from a legalistic viewpoint in which the constitutionality of such a measure can be seriously questioned. In other words we have here the Federal Government endeavoring to dictate to the States and municipalities as to their planned industrial development. Secondly, and of more importance to the commissioner, is that this legislation will prevent planned provision for industrial growth which in turn will take care of our ever-increasing employment requirements or to put it quite frankly, the proposed legislation may very well prove an insurmountable hindrance in providing jobs for the growing generations.

"A case in point might be the proposed move of Northwest Orient Airline from St Paul to Seattle. This move originated entirely with Northwest Orient officials as certain conditions at their existing overhaul base required a solution which might mean moving to Seattle. The company submitted inquiries to the port of Seattle commission which in turn made a proposition to the company which involved the port of Seattle commission building for the company a $15 million overhaul base. This base would cost $15 million, which sum the port intended to raise by issuing revenue bonds which would be pledged against the overhaul base and that only. The company would amortize the bonds over a period of 20 years at an annual rental of say $1 million a year. They would, of course, under existing law, charge off the rental as a business expense and deduct it from their income-tax payments.

"Under the proposed law this deduction from gross income for income tax purposes would be denied the airline company and of course the entire deal, if for no other reason, collapsed. Down in Portland, Oreg., the commission of public docks was executing a multi-million-dollar lease with a grain company when the grain company served notice on the commission that in view of the proposed legislation all further negotiations would have to be suspended.

"But of more importance is the development of the Duwamish Valley where at the present moment the city, county, and port are spending $45,000 on a preliminary engineering survey. The plans are for this development, that if the engineering survey so indicates, the port of Seattle will eventually, after a vote

of the people approving a bond issue, buy up the acreage involved and prepare industrial sites bordering on deep water. This is the area that provides the industrial sites so necessary for the future growth of Seattle and this area. It was visualized that manufacturers wishing to build might very well require financial help, especially our own industrialists who want to put up a factory but do not have sufficient capital. The port intended to use revenue bonds, pledged against the particular factory, in order to provide the necessary capital.

"About 5 years ago the port of Seattle commission purchased what is called the Pacific Coast Coal property The owners, mostly New Englanders, had wanted to liquidate their interests in the property so had made an offer to the commission. After extended negotiation the commission purchased the property through the use of revenue bonds In other words, title to the property passed to the port at absolutely no expense to the taxpayers. The revenue bonds of $1,800,000 were issued against the Pacific Coast Coal properties only and the income from those properties have been retiring the bonds up to date. If the income from the Pacific Coast Coal properties should at any time depreciate to the extent that the bonds could not be further retired, there would be no responsibility incurred by the taxpayers of King County. The only recourse the bondholders would have would be to hope that the time would soon arrive when income from the property would once again be sufficient enough to retire the bonds. There is a grave question involved that if the present legislation should become a law, a new tenant on the Pacific Coast Coal properties, say that tenant was canning salmon eggs, would be unable to charge off for income-tax purposes the rent he would be paying the port.

"Hearings are being held this date before the Senate Finance Committee in Washington, D C Our Senators Magnuson and Jackson are well aware of the potential threat that this proposed legislation has to our future economy here in the Pacific Northwest However, there are apparently a number of United States Senators who have little knowledge of what the proposed legislation contains. In this connection it should be pointed out that the House Ways and Means Committee action was taken in executive session without public hearings The bill was reported out to the House on a take-it-or-leave-it basis under a rule which prohibited amendments It passed the House and is now before the Senate Finance Committee which will act in the next few days.

"Basically this provision stems from the alleged raiding of the New England industry by southern communities However, the law is not limited to the prevention of such alleged raiding. Here in the Pacific Northwest we have new lands which are growing rapidly and are attractive to industry which has no thought of escaping from any existing labor market or tax problem. Every day new industries are born or organized with wholly new capital which never had existence or location before and which may for proper reasons desire to locate here in the Pacific Northwest. The municipality concerned may very properly wish to attract this type of industry with a plant properly financed by revenue bonds. Section 274 will wipe out this type of establishment.

"If we in the Pacific Northwest are to make proper plans for the growth of our area, section 274 of H. R. 8300 must be completely erased and done away with otherwise, if use of revenue bonds is contemplated, our planning will be predicated on what the Federal Government through this tax law will permit us to do," Rowe concluded.

MIDWEST MINERAL CO.,
Greenwood, Ind., April 29, 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SIR: I have been in correspondence with my Congressman, William G. Bray of the 7th District of Indiana, and Senators Jenner and Capehart, regarding a suggested change in the revenue bill, H. R. 8300. Senator Jenner informs me that this is now up before the Senate Committee on Finance.

This suggestion is that a farmer or businessman should be able to sell real property and reinvest in property of like kind within a certain period of time, the same as is provided presently for homeowners. This discussion of the homeowners provision is on page 78 of House Report No. 1337, under the title "Gain or Loss on the Sale of Property."

Such a provision would make for a freer handling of business investment, such as farm property and business property. Under the present law, the only way property can be disposed of without tax liability, is a direct exchange. This is very hard to accomplish. On account of a personal instance I became interested in this part of the tax law. I own a small farm which had been purchased in 1932 and started to sell it in order to buy a large farm which was in the hands of an estate. However, the only way the sale could be made without tax liability was by exchange. I had to let the deal fall through, because the trust company handling the estate was not interested in such a proposition. Consequently, the large farm sold to a doctor for investment purposes and its barns and yards for livestock are lying idle, whereas if I had purchased it, there would have been 30 to 40 brood sows and 30 to 40 cows on the place this year. This would have meant much more business and consequently much more tax for the Government in the long run.

While I became interested in this provision on a personal standpoint, yet the more I study it the more I see how it will affect the young businessman who can only buy a small amount of property to start with. Many a young farmer for instance wants to own his own home and will invest in a small 40-acre farm in order to get his start. If he could handle his property like the present provision for sale of a home, then he could sell this small property and reinvest within a certain time in another farm. As long as he reinvests in property of like kind, the Government is going to get tax from the property and often would get much more tax, because of the larger investment and larger amount of business being transacted.

Such a provision inserted in the new law would make for better business in general. Senators Jenner and Capehart and Congressman Bray have indicated a great interest in this provision and I believe a study of it on the part of your committee will make it possible to work it out to the benefit of the entire country. I hope that this suggestion meets with your approval.

Yours truly,

MAURICE JOHNSON.

DAVID BERDON & CO.,
New York 17, N. Y., April 16, 1954.

Hon. JACOB K. JAVITS,
House of Representatives, Washington, D. C.

DEAR MR. JAVITS: I am addressing this letter to you in the hope that you can arrange to bring the contents of this to the attention of the Senate Finance Committee which is now in the midst of considering H. R. 8300, which is the proposed Revenue Code submitted to and adopted by the House of Representatives.

The aforesaid H. R. 8300 contains section 336, which deals with the income-tax effects of a partial liquidation of a corporation. Two conditions are described for qualification as a partial liquidation. The second condition, namely (a) (2), is in turn broken down into 3 additional requirements.

Section 336, which is obviously and avowedly designed to disqualify some transactions now deemed to be in the nature of partial liquidations under the Internal Revenue Code of 1939, is in my opinion, in a large measure, justified, although from my own experience there has been no abuse of the present statute, first, because of intelligent and extremely competent administration by officials in the Internal Revenue Service and, second, because of the practical and discerning judicial attitude adopted by the courts. Notwithstanding this thoroughly satisfactory judicial climate and high competence on the part of the Internal Revenue Service in the administration of the existing statute, I have indicated that section 336 as proposed in H. R. 8300 seems satisfactory because I believe a section is wisely conceived when its contents deal with a situation with such specificity and with such clarity of articulation that all persons who must resort to the section will be aware of its requirements for literal and spiritual compliance.

In a desire to be specific, coupled with an intent to eliminate possible abuse of a remedial provision of a taxing act, it sometimes happens that textual particularity will let seep through an obvious inequitable result. This is evident in one of the requirements of section 336, to wit, (a) (2) (A) "books and records for such terminated business are maintained by the distributing corporation separately from the books and records maintained by such corporation for such period for such other business or businesses."

There is no ambiguity about this language. Consequently, if one taxpayer satisfies every condition contained in section 336 except the fact that the books

and records of such taxpayer were not arranged in a fashion to satisfy (a) (2) (A) supra, this taxpayer's partial liquidation is outside the ambit of partial liquidations. On the other hand, another taxpayer seeking the benefit of this section, whose circumstances in regard to his partial liquidation will differ only in that his books of account have by happenstance been arranged so as to meet the definition of (a) (2) (A) above, will be treated differently and on a much more favorable basis in income tax result than the first taxpayer.

Section 336, as framed, transparently benefits the large corporation maintaining expensive and costly accounting records under the supervision of highly trained and skilled auditors but operates to the prejudice of the small taxpayer who cannot afford a large accounting office or personnel or complex and expensive bookkeeping systems.

If substantial justice is to be done in respect to all taxpayers who are comparable in all circumstances in connection with partial liquidations, save in regard to the manner and method of keeping records, then section 336 should be amended to permit taxpayers to conform their records for prior years so as to meet the recordkeeping condition of the section. If the suggestion advanced in the preceding sentence is found objectionable, then instead of the requirement for separate books and records, the section should be amended so that if income of the terminated business can be computed from the presently maintained accounting records, such computation or determination should suffice.

A lot of printers' ink has been devoted to the pronouncement of the courts on the subject of form versus substance. If taxes are to depend upon the realities of a transaction, the realistic and material portions of the transaction should be considered and not the immaterial that have no real influence on its true nature.

I hate to see a section which is so well designed in its purpose destroyed by the inclusion, to wit, of a condition which is so obviously an inequitable one. I should appreciate it immensely if you could do something to bring the contents of this letter to the attention of someone in the Senate Finance Committee in order that the purpose and context of section 336 be reexplored to eliminate what would be tantamount to a grave miscarriage of fair treatment to a segment of taxpayers.

Very truly yours,

MAURICE S. PREVILLE.

OREGON FARM BUREAU FEDERATION,
Salem, Oreg., April 27, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: As chairman of the Senate Finance Committee, the Oregon Farm Bureau Federation would like to submit to your attention the following statement relative to H. R. 8300 which concerns tax regulations for corporations and individuals receiving dividends.

At the present time, both general corporations and insurance corporations receive the same fair treatment under the Federal income-tax law—entitling the credit against net income of 85 percent of the dividend received from other corporations. Section 246 (a) (1) of H. R. 8300, provides, however, for a major change in the existing law by excluding insurance companies from this normal, fair practice and the Oregon Farm Bureau Federation wishes to oppose this proposed change on the existing law as well as oppose section 34 (c) (1) which would not allow a credit against the income tax of an individual of a percentage of dividends received from an insurance corporation. The Oregon Farm Bureau Federation has a vital interest in this bill as we have organized an Oregon Farm Bureau insurance company as a service program for farm bureau members only. This program has proven to be not only beneficial to the members but of economical interest as well. The Oregon Farm Bureau Insurance Co. is a stock company organized under the corporate laws of Oregon and we believe, a credit to the free-enterprise system.

Because farm bureau insurance companies are organized as a service for members, it is sometimes necessary for farm bureau States to combine on a multistate basis in order to provide sufficient business for a sound insurance operation. The Western Farm Bureau Life Insurance Co., which was organized in 1952, is an example of this farm bureau cooperative effort. This company is

a legal reserve stock company with its capital stock owned by the six cooperating farm bureau States. Oregon is 1 of the 6 Western States involved. The Oregon Farm Bureau Service Co. in turn has sold its capital stock to individual farm bureau members. We look toward this parent company (Western Farm Bureau Life Insurance Co.) for dividends on stock held in the life company as income to meet the dividend obligations of the stock held by individual farm bureau members. The passage of section 246 (a) (1) in H. R. 8300 would create a serious financial problem to our organization.

These organizations were organized in all good faith under existing law and it would seem quite inequitable to require an altogether new tax treatment that would prove to be a serious financial handicap to both the insurance corporations involved and the individual receiving dividends from insurance companies.

It would not, therefore, seem to be in the public interest to discriminate against organized insurance companies and to take away that right which both insurance corporations and individuals possessed at the time the company was organized or at the time the individual purchased their stock.

May we respectfully request, therefore, that H. R. 8300 be so amended as to eliminate section 246 (a) (1) and section 34 (a) (1) from the original bill and that this statement be entered as a part of the official hearing.

Sincerely yours,

George W. Dewey,
Executive Secretary.

Muecke, Mules and Ireton,
Baltimore 2, Md., April 30, 1954.

Re H. R. 8300, section 6323

Miss Elizabeth B. Springer,
Chief Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

Dear Miss Springer: I am enclosing 35 copies of a statement with reference to the above which I would appreciate your including in the record on this bill.

With kind regards, I am

Sincerely,

J. Francis Ireton.

Statement of J. Francis Ireton Suggesting an Amendment to Section 6323 of H. R. 8300

To the chairman and members of the Senate Finance Committee:

INTRODUCTION

Section 6323 relates to tax liens and is comparable to section 3672 of the present Internal Revenue Code. A tax lien is in the nature of a secret lien in that it is given no notoriety by any public filing such as is the case with respect to liens generally. The section as drafted poses two serious problems.

First, subsection (a) thereof provides for an arbitrarily limited class of persons who may take a perfected lien or security interest on the property of a taxpayer after a tax lien has arisen, and as against whom such a secret unfiled tax lien is ineffective. It is suggested that this unwarranted and narrow classification should be abolished and the classes of persons protected enlarged.

Secondly, subsection (c) thereof is new law and in uncertain and not clearly defined situations makes an unfiled secret tax lien superior to a previously perfected lien or security interest that has been given notoriety by a public filing. It is suggested that this provision be changed to eliminate this new idea so as to make the subsection the same as existing law.

THE PRESENT LAW

Under sections 3640 and 3641 of the Internal Revenue Code, the Commissioner is authorized to make assessments and certify such assessments to collectors for collection.

Under section 3671, Internal Revenue Code, a tax lien arises in favor of the Government for unpaid taxes when the assessment list is received by the collector. The priority of this lien, as against other liens on the same property, except as otherwise provided by section 3672, is determined by the time as of

which the collector receives the assessment list. This lien continues as a secret lien, without the necessity of any public filing or notice, until it is satisfied or otherwise discharged in accordance with particular circumstances specified by statute.

However, under section 3672, Internal Revenue Code, this secret unfiled lien of the Government for unpaid taxes is invalid and ineffective as against any mortgagee, pledgee, purchaser, or judgment creditor until a notice of the lien has been filed by the collector in a specified office, and this filing is in the nature of a public notice just as is the filing or recording of a chattel mortgage or other security device.

It has also been held that actual knowledge of the existence of a secret unfiled tax lien by a secured creditor is not a substitute for the required filing in order to give the Government priority as against such a mortgagee, pledgee, purchaser, or judgment creditor who may have such knowledge. The effectiveness of the Government's lien as against such limited classes of persons is determined by the definitely prescribed act of filing a public notice, and this method of perfecting the Government's tax lien as against such persons is execlusive. See *United States* v. *Beaver Run Coal Company*, 99 Fed. (2) 610.

THE PROPOSED LAW EMBODIED IN H. R. 8300

Section 6203 (comparable to secs. 3640 and 3641, Internal Revenue Code) provides that the assessment of taxes shall be made by the recording of the liability of the taxpayer in the Office of the Secretary or his delegate. This recording may be done by mechanical process.

The date of the making of the assessment as authorized becomes important because, under section 6322 (comparable to sec. 3671 Internal Revenue Code) the lien of the Government for taxes arises when the assessment is made and not as heretofore when the assessment list is received by a collector. Assessments under this proposal conceivably could be made before the due date of a tax or certainly as of the due date even though payment is not then made because of a disputed question of liability.

Section 6323 (comparable to sec. 3672 Internal Revenue Code) in subsection (a) continues the present provision making an unfiled tax lien ineffective as against a mortgagee, pledgee, purchaser, and judgment creditor, as to which some change should be made. In addition, a new provision is contained in subsection (c) substituting notice which can be charged to a secured creditor in order to subordinate such secured creditor's position to the secret unfiled tax lien of the Government instead of the present required filing.

SUGGESTED AMENDMENT TO SECTION 6323, SUBSECTION (A)

It is respectfully submitted and earnestly urged for reasons hereinafter stated that the classes of lienholders to be protected under subsection (a) should not be restricted to the narrow categories of "mortgagee" or "pledgee" and hence the subsection should be amended to embrace all perfected lien or security interests and to read as follows. The matter to be deleted is enclosed in black brackets, and the new matter to be inserted is in italics.

"INVALIDITY OF LIEN WITHOUT NOTICE.—Except as otherwise provided in subsections (c) and (d), the lien imposed by section 6321 shall not be valid as against any [mortgagee, pledgee,] *holder of a perfected lien or security interest*, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate—."

REASONS FOR THE SUGGESTED AMENDMENT

Because of the secret nature of Federal tax liens, section 3672, Internal Revenue Code, was originally enacted to reverse the effect of cases such as *United States* v. *Snyder* (149 U. S. 210) where this secret lien was held to be superior to a valid security arrangement. As originally enacted, pledgees were not included within the class of lienholders protected, and the section was subsequently amended in 1939 to cure this apparent oversight and to overcome the effect of cases such as *United States* v. *Rosenfield* (26 Fed. Supp. 433). Hence we have an established congressional policy to protect otherwise valid and perfected lien or security interests against this secret unfiled lien of the Government.

Since this statute was originally enacted other kinds of security devices have evolved and come into widespread use as substitutes for mortgages and

pledges such as the Trust Receipts Act, the Factor's Liens Act, and more recently the uniform commercial code. All of these statutes require the debtor and the secured financing institution to publicly file a notice with respect to their lien or security rights but in each instance the holder of the security interest does not specifically fit the limited category of a "mortgagee" or "pledgee."

Under the Trust Receipts Act, the debtor is called a trustee, the lienholder an entruster, and the lien a security interest. Under Factor's Lien Acts the debtor is a borrower, the lienholder a factor, the lien a general lien. Under the commercial code, the debtor is called a debtor, the lienholder a secured party, and the lien a security interest.

The Uniform Trust Receipts Act has been enacted in 31 States and 2 Territories, as follows: Alabama, Alaska, Arizona, California, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Oregon, Pennsylvania, South Dakota, Tennessee, Utah, Virginia, Washington, Wisconsin, and Wyoming.

Briefly, this security device in operation is very similar to an assigned conditional sale contract. It is uniformly used in financing the distribution of motor vehicles and other consumer hard goods under which the distributor or retailer acquires such motor vehicles and consumer goods as its inventory for resale.

Factor's Lien Statutes have been enacted in 23 States, as follows: Alabama, Connecticut, Delaware, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, West Virginia, and Wisconsin.

This device is similar to a series of chattel mortgages and is customarily used in the financing of inventories of producers of raw materials and manufacturers.

The Trust Receipts Act was promulgated and first enacted in New York in 1933. The Factor's Lien Acts originated in an act passed in New York in 1911, but the majority of the States that have enacted this type of a security arrangement did not adopt their law until after 1940.

The uniform commercial code so far has only been enacted in Pennsylvania but it has just recently been promulgated by the Commissioners on Uniform State Laws, it having been approved by the American Bar Association in September 1951. It currently is under consideration by public or semipublic bodies in approximately 15 States for legislative action by those States, and it is hoped that it will be widely enacted. This code is the result of over 10 years' study by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. Article 9 thereof is a consolidation of all of our presently known chattel security devices such as mortgages, pledges, conditional sales, trust receipts, factor's liens, etc., and amalgamates them all into a single lien concept known as a security interest held by a creditor called a secured party. If the code becomes widely enacted, as is hoped, it would seem that there is a strong possibility that a secured party holding a security interest thereunder is not within the category of a "mortgagee" or "pledgee" specified in section 6323 (a).

It has generally been thought by lawyers conversant with these matters that the holder of a perfected security interest, no matter how designated, was protected against secret unfiled tax liens under section 3672 of the Internal Revenue Code. However, recent cases decided under the section have contained dicta to the effect that the classes of persons protected thereunder are only those "specifically included in the statute and no others." For illustration see *United States* v. *Security Trust and Savings Bank* (340 U. S. 47) and *United States* v. *Eisinger Mill and Lumber Company* ((Md.) 98 Atl. (2) 81).

As a result of this dicta the Government has recently contended in pending cases that an entruster under the Trust Receipts Act was not a mortgagee or pledgee, and therefore was not protected as against an unfiled tax lien.

Of course, with the abolition of conditional sale contracts under the uniform commercial code, it is reasonable to assume also that conditional sellers of merchandise will lose the protected status accorded them under cases such as *United States* v. *Anders Contracting Company* (111 Fed. Supp. 700) since under the code the retention by a seller of title to merchandise sold will become a security interest.

It is difficult to believe that Congress intended to protect only mortgagees and pledgees and discriminate against other valid security interests. No reason is

apparent for such a distinction. In view of the omission of pledgees in the original section, and their prompt inclusion, it can only be assumed that the failure to include other normal holders of lien and security interests was either an oversight or resulted from the fact that these other types of security arrangements were not known or were not so widely used when the section was originally enacted.

There is an immediate urgency to make the change above suggested in subsection (a) not only because of the tremendous volume of financing done under trust receipts and factor's liens, and the imminent enactment of the uniform commercial code, but also because of the change in the law that tax liens will arise at an earlier date than heretofore, namely when the liability of a taxpayer is recorded, probably mechanically, instead of when an assessment list was sent a collector which was usually well after a due date.

The possible existence of such secret tax liens arising on or even before the due date of a tax, without public notoriety being given them, and of their being superior to an otherwise valid and publicized security interest or lien under a trust receipt, factor's lien, or under the commercial code, will adversely affect the extension of secured credit to distributors and retailers of motor vehicles and other consumer goods. Most such business entities are small business and are not adequately capitalized and therefore must have such secured credit for continued existence. The drying up of such secured credit could conceivably disrupt the normal distributing processes of our economy.

It is therefore respectfully, but most earnestly, urged that subsection (a) be amended as hereinbefore suggested.

SUGGESTED AMENDMENT TO SECTION 6323, SUBSECTION (C)

Subsection (c) of section 6323 should be amended as follows (the matter to be deleted being enclosed in black brackets and the new matter being in italics):

"LIEN VALID WITHOUT NOTICE IN CERTAIN CASES.—The lien imposed by section 6321 shall be valid, without the filing of notice thereof, as against any [mortgagee, pledgee, purchaser, or] judgment creditor, if—

"(1) [in the case of a mortgagee, pledgee, or purchaser, such mortgagee, pledgee, or purchaser had notice or knowledge of the existence of such lien at the time the mortgagee, pledgee, or purchaser was made, or]

"[(2) in the case of a] the judgment creditor [, the creditor] has not obtained a valid judgment in a court of record and of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money, or

"(2) [in the case of a] *the* judgment creditor [who] has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money, *but has not perfected a lien under such judgment* with respect to the property involved [has been perfected under such judgment]."

As thus changed, subsection (c) would read as follows:

"LIEN VALID WITHOUT NOTICE IN CERTAIN CASES.—The lien imposed by section 6321 shall be valid without the filing of notice thereof as against any judgment creditor, if—

"(1) the judgment creditor has not obtained a valid judgment in a court of record or of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money, or

"(2) the judgment creditor has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money but has not perfected a lien under such judgment with respect to the property involved."

REASONS FOR THE SUGGESTED AMENDMENT

Under present law, the effectiveness of the Government's tax lien as against specified classes of liens or security interests is determined by the definitely prescribed act of filing a public notice. This is a simple, objective test, which affords certainty as to the date as of which the rights of the parties are fixed. The need for any change in this rule has not been shown, and none apparently exists.

Once a notice of tax lien is filed pursuant to the statute, then anyone subsequently taking a lien or a security interest in property of the taxpayer does so

subject to the tax lien. There is no suggestion that this should in any way be changed.

Under the proposed subsection (c), an existing tax lien as to which no notice has been filed could become superior to a lien or security interest taken in good faith merely because the secured party may, as the result of subsequently produced evidence, be chargeable with notice of the fact that the tax lien did exist.

As a result of the other changes made in the provisions of H. R. 8300 with respect to when a tax lien arises, this problem becomes extremely serious. A tax assessment, which would give rise to a lien, may be made against a taxpayer who is not even in default upon the recording of the taxpayer's return by mechanical process, prior to the due date of the tax. The taxpayer by his return in effect assesses a liability against himself in favor of the Government. Since the liability of taxpayers will probably be recorded by mechanical process under regulations to be promulgated, this may have the effect of putting the world on notice of the fact that every taxpayer who has filed a return and not paid a tax, at least by the due date, may have a tax lien existing against him. This would be true even though nonpayment may result from a valid dispute as to the question of liability for the tax. Under such circumstances, a secured lender could never be sure that its lien or security interest may not some day be subject to attack as against a competing tax lien which had never been filed.

This provision would superimpose upon the present simple, objective test of a filing, an additional subjective one, depending largely upon circumstances developed in testimony after the fact, to be resolved out of conflicting factual situations, the final determination of which probably would rest in a jury verdict years after the event. In place of precision under present law, subsection (c) as drafted substitutes uncertainty and doubt.

Obviously the question arises as to what is notice to a large financing institution. It is conceivable that some officer or employee of such an institution could be charged with notice of the fact of the existence of an unfiled tax lien without the officers of the institution who may be handling the particular transaction having real actual knowledge. This proposal would certainly cast an onerous and unfair burden on the banks and other financing institutions of the country.

A further reason for amending subsection (c) as above suggested is the fact that under subsection (e) of section 6323, the Secretary or his delegate is only authorized to give information as to the amount of taxes secured by a tax lien if a notice of lien has been filed. Until notice has been filed, it would be impossible for any financing institution to secure information with respect to the tax liability or the existence of a tax lien against a prospective borrower. Subsection (e) therefore seems to require the change hereinbefore suggested.

It is accordingly urged that subsection (c) of section 6323 be amended as hereinbefore proposed to restate our present law.

SECTION 6323 (D)

If the changes above suggested are made, then a conforming change should also be made in subsection (d) by deleting the words "mortgagee, pledgee" and inserting in lieu thereof the words "holder of a perfected lien or security interest."; and by deleting the words "of such mortgage, pledge" and inserting in lieu thereof "of the creation of such lien or security interest."

Respectfully submitted.

MUECKE, MULES AND IRETON,
By J. FRANCIS IRETON.

IDENTITY OF THE WITNESS

The writer is a member of the law firm of Muecke, Mules and Ireton, 1004 First National Bank Building, Baltimore 2, Md., and is of counsel to Commercial Credit Co. and its subsidiaries. The latter, in addition to its other activities, is in the business of financing nationwide the distribution, marketing, and retail time sale of industrial and commercial machinery and equipment and consumer goods of all kinds. The volume of such business done by said company and its subsidiaries in 1953 was slightly in excess of $3 billion.

JONES & LAUGHLIN STEEL CORP.
Pittsburgh 30, Pa., April 30, 1954.

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

DEAR SENATOR MILLIKIN: The enclosed five suggested amendments to H. R. 8300 are submitted to you for your consideration in the efforts that the Senate Finance Committee is making to clear up inequities and noncontroversial matters yet remaining in the bill.

These suggestions may be summarized briefly as follows:

1. Carry-forward of contributions by corporations to charitable and other organizations in excess of the 5 percent of income limitation.
2. Permission to inventory at cost or market, whichever is lower, certain materials and supplies consumed in the productive process, whether or not they become physically part of the finished product, thus restoring the practice in effect prior to 1933 and giving effect to recognized accounting principles.
3. Clarifying changes to insure percentage depletion on extraction of minerals from waste deposits to a lessee-operator who has had his lease extended, renewed, or modified and to an acquiring corporation in a tax-free transaction.
4. A new provision to permit advanced royalties paid under mining leases to be deducted either in the year paid or deferred until the mineral against which they are applied is used or sold, thus putting these royalties on a basis similar to that for development costs under section 616 of the bill (sec. 23 (cc) of the Internal Revenue Code added by the Revenue Act of 1951).
5. In the case of acquisition of land and buildings with intent to demolish and replace the old buildings, a provision which will allow the cost allocable to the old buildings plus their demolition cost to be added to the cost basis of the new buildings for depreciation and other purposes instead of being treated as part of the cost of land.

Each of these suggestions will correct serious inequities in our existing tax laws. Since they cover isolated situations, the loss in revenue should not be material. I urge that they be given consideration in the forthcoming executive sessions of the Committee on Finance.

Sincerely,

C. L. AUSTIN.

SECTION 170 (b) (2)—CONTRIBUTIONS TO CHARITABLE, EDUCATIONAL ORGANIZATIONS, ETC.

Under present law a corporation is not allowed a deduction for charitable contributions in excess of 5 percent of its net income for the year of the contribution (computed without benefit of the contributions deduction). Frequently, contributions exceed that amount through no fault of the taxpayer. Thus, a corporation may make normal contributions during the first part of the year and have its entire net income wiped out by a strike in the latter part of the year. It never gets a tax benefit from the contributions made under those or similar circumstances. This situation should be corrected by permitting corporations to carry forward such excess contributions to future years. This is permitted in the case of excess contributions to exempt employee trusts. No sound reason exists for not providing the same treatment for contributions to charitable and similar organizations.

Recommendation.—That amounts contributed by corporations to charitable, educational, and other similar organizations in excess of the 5-percent limitation be allowed as a carry-forward for succeeding years. This can be accomplished by adding the following provision at the end of section 170 (b) (2): "Any amount paid in any taxable year in excess of the amount deductible in such year under the foregoing limitation shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitation."

SECTION 471—INVENTORIES—SUPPLIES

The internal revenue laws have never defined the items which are properly includible in inventory. This has always been covered by regulation. Prior to 1933 the regulations permitted all materials consumed in the productive process

to be inventoried. Under this provision all supplies used in the manufacturing process, including such items as fuel oil, coal for power purposes, etc., could be inventoried at the lower of cost or market. In 1933 the regulations were amended to restrict inventoriable items to materials which become a physical part of the finished product for sale. Thereafter, the Commissioner insisted that supplies could only be inventoried at cost and could not be reduced to market where their market value had declined. The purpose of the change in the regulations was to bolster sagging Federal revenues during the depression years and had no relation to sound accounting principles. The practice which prevailed prior to 1933 should be restored.

Recommendation.—(1) That section 471 of H. R. 8300 be amended to specifically include materials and supplies used or consumed in productive or mining processes as items of inventory. To accomplish this, the following sentence should be added at the end of section 471:

"Inventories shall include raw materials and supplies on hand acquired for sale, consumption or use in productive processes (whether or not they will physically become a part of merchandise intended for sale), together with all finished or partly finished goods, except that if the taxpayer carries materials or supplies on hand which will not physically become part of merchandise intended for sale and for which no record of consumption is kept (or of which physical inventories at the beginning or end of the year are not taken), it will be permissible for the taxpayer to deduct from gross income the total cost of such supplies and materials for the taxable year in which purchased provided the taxable income is clearly reflected." (This suggested language is derived from article 1581 of regulations 45 and sections 39.22 (c)-1 and 39.23 (a)-3 of regulations 118.)

Recommendation.—(2) Where a taxpayer which has consistently inventoried such supplies at the lower of cost or market since prior to 1933, filed a proper election to value such inventories under the last-in first-out method and was denied such election by the Commissioner on the ground that supplies are not items of inventory under the 1933 regulations, section 471 should be amended to permit such taxpayers to value such supplies under the last-in first-out method beginning with the year for which the election was filed and permit adjustments to tax for all years affected whether or not closed by the statute of limitations.

SECTION 613—PERCENTAGE DEPLETION

Section 613 (c) (3) is an attempt to clarify existing law with respect to the percentage depletion allowance for minerals extracted from the waste or residue of prior mining. The obvious intent of this paragraph is to limit the allowance to the taxpayer who did the mining from which the waste or residue results, since a "purchaser" of the waste or residue is specifically excluded from benefits of this paragraph. However, the manner in which the paragraph is now framed, particularly the second sentence, is open to a possible interpretation that an operator-lessee who extends or renews his lease would be considered a "purchaser" and thus deprived of the percentage depletion allowance. Also an acquiring corporation in a tax-free transaction could also be considered a "purchaser" and similarly excluded. Since it is apparent that neither of these results is intended, it is suggested that appropriate clarifying amendments be made.

Recommendation.—That section 613 (c) (3) be amended to read as follows (new material italicized; omitted material in black brackets):

"(3) EXTRACTION OF THE ORES OR MINERALS FROM THE GROUND.—The term "extraction of the ores or minerals from the ground" includes the extraction by mineowners or operators of ores or minerals from the waste or residue of *their* prior mining, *provided that their economic interest in such waste or residue is continuous from the time of such prior mining to the time of extraction of ores or minerals from such waste or residue.* [The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom]. *An acquiring corporation described in section 381 which has at any time acquired such mineral or residue or the rights to extract ores or minerals therefrom in a transaction described in said section, shall be deemed a mineowner or operator for the purposes of the preceding sentence of this paragraph.*

(NOTE.—It may be more desirable to include the substance of the last sentence of the above recommendation as a new subsection under section 381).

NEW SECTION 617—DEDUCTION OF ADVANCED ROYALTIES IN THE CASE OF MINES

Most mining leases contain provisions requiring the lessee to pay a minimum royalty each year, irrespective of whether any ore is extracted from the leased property. Any such minimum royalty paid in excess of the amount paid for ore extracted during the year is normally applied against future production if and when mined. The courts long ago held that such royalties constitute rent and must be deducted in the year paid or incurred. This constituted a severe hardship to many taxpayers, particularly during the depression years when their properties were inactive and they had no income against which to deduct the royalties. The Treasury, apparently in recognition of the inequities in this situation, amended its regulations in 1940 to permit taxpayers an election either to deduct such royalties in the year paid or defer the deduction until the ore against which they are applied is mined. (See Regulations 118, sec. 39.23 (m)–10.) However, the amended regulation makes the election binding with respect to all properties leased by the taxpayer and all future taxable years. Numerous taxpayers elected to defer their advanced royalties with the result that they are now prevented from deducting them in the year paid or incurred. During the intervening years minimum royalties in mining leases as well as tax rates have become progressively higher. Thus a policy of deferring the deduction of such royalties is much more costly today than it was in 1940 and prior years. The taxpayer should be given an election with respect to advanced royalties similar to the annual election provided in section 616 for development costs, which permits taxpayers to deduct such costs for any property in the year paid or incurred or to defer the deduction to the year in which the mineral benefited by the development work is extracted. The least that should be done is to permit taxpayers a new election under the existing regulation effective for years beginning with 1954.

Recommendation.—That a new section 617 be added to part I, subchapter I, chapter 1 as follows:

"SEC. 617. ADVANCED ROYALTIES

"A lessee or other owner of operating rights with respect to a mineral interest who is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalties on mineral thereafter extracted, may at his election treat the advanced royalties so paid or accrued in either one of the following maners:

"(a) as deductions from gross income for the year the advanced royalties are paid or accrued, or

"(b) as deductions from gross income for the year the mineral product in respect of which the advanced royalties were paid is used or sold.

The election under this section may be made for each separate mineral interest and shall be binding only for the taxable year for which made."

SECTION 1016 (A)—REMOVAL OF OLD BUILDINGS

Purchase of real estate with intent to remove and replace old buildings.—This situation is not covered either under existing law or H. R. 8300. Under existing Treasury regulations where a taxpayer purchases improved real estate with the intention of demolishing and replacing the improvements, the entire purchase price is considered as the cost of land even though the improvements may have considerable value at the time of purchase. For example, if a taxpayer purchases improved real estate for $2 million and the land and improvements each have a fair market value of $1 million, the taxpayer's investment in land is considered to be $2 million. He gets neither a loss deduction for the demolition of the old improvements nor may he add the $1 million cost of the old improvements to the cost of the new improvements and recover it by way of depreciation over the life of the new improvements. If he has a loss, he recoups it only at the time he disposes of the land.

This constitutes a serious impediment to the rehabilitation of real property. One of the problems facing many large cities today is the rehabilitation of industrial and commercial areas and clearance of slums. Industry has been called upon in many instances to aid in such projects by buying the land, removing the old improvements and installing new and up-to-date industrial facilities. Such projects would be encouraged if taxpayers were permitted to recover by way of depreciation amounts expended for the real estate in excess of the fair market

value of the land. Such treatment of these excess expenditures is sound under generally accepted principles of accounting. Under the Treasury's present method of requiring all such costs to be capitalized as part of the cost of land, the taxpayer's books will show inflated land values and thereby mislead the shareholders and public alike as to the true worth of its assets. A rule should be adopted which will not only eliminate these defects but at the same time make it unnecessary to determine the taxpayer's intent in cases of this kind. The latter objective is consistent with the basic principle underlying the entire new tax revision law and should be given effect wherever possible.

Recommendation.—Amend section 1016 (a) to provide that where a taxpayer purchases improved real estate, the portion of the purchase price allocable to the improvements plus any demolition costs shall be added to the basis of new improvements replacing the old improvements where the new improvements are commenced within 5 years from the date of purchase. To prevent abuse of this rule in cases where the new improvements are insignificant in character, such as where the taxpayer purchases improved real estate and converts it into a parking lot, the rule should be made to apply only where the cost of the new improvements equals or exceeds the purchase price of the land and old improvements.

UNDERWRITERS' LABORATORIES, INC.,
New York, N. Y., April 29, 1954.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.:

Underwriters' Laboratories, Inc., is a nonprofit corporation organized to test equipment and materials from the standpoint of safety to the public. It is sponsored by the stock fire insurance companies, as a public service, but is self-supporting by virtue of fees charged to manufacturers for its services.

State and municipal authorities utilize the findings of Underwriters' Laboratories in their efforts to get safe equipment in the hands of the public. The Federal Government uses them as a guide in its purchasing. From this standpoint it is a quasi-public, but privately operated testing organization. There are no stockholders and the articles of incorporation preclude the paying of a dividend or profit to anyone. It was originally declared tax exempt, but in 1942 the Board of Tax Appeals supported the Commissioner of Internal Revenue in the decision that section 101 (6) of the Revenue Acts of 1936 and 1938 did not grant tax exemption under the intent of the term "scientific." This position was supported by the United States Circuit Court of Appeals for the Seventh District, Nos. 8141 and 8145. Since that time income taxes have been paid on any earnings set aside for the purchase of new or improved test facilities. Tax exemption was also thereby lost in the various States where Underwriters' Laboratories operates, and the nature of its service requires operation on a national scale.

As a consequence of the foregoing, it has been most difficult to expand testing facilities to keep pace with the expansion of industry, and inspection and regulatory authorities have not had the guidance needed for much new equipment. This is particularly true in the oil burner and air-conditioning fields where expansion has been greatest in recent years. It is, therefore, respectfully requested that subparagraph C-3 of section 501 of H. R. 8300 be modified by the insertion of the words, "testing for public safety," immediately following the term "scientific," so as to renew the tax exempt status of Underwriters' Laboratories, Inc., and thereby enable it to expand its testing facilities out of earnings. Equipment and materials for general use may then be tested for safety prior to their sale to the general public and regulatory authorities charged by local ordinances with supervising the safety of the public, will have the guidance that has been available for over half a century.

The amended 501 C (3) would read, "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, *testing for public safety*, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation." The italicized section is the amendment proposed.

MERWIN BRANDON.

STATEMENT BY RANDOLPH W. THROWER ON SECTION 481 OF H. R. 8300

This statement is submitted to the Committee on Finance, United States Senate, with the request that it be placed in the record of hearings on H. R. 8300.

I wish to call the attention of the Finance Committee to one section of the pending Internal Revenue Code which I believe to be unfair and extremely harsh to the taxpayers who will be affected by it. I refer to section 481 of H. R. 8300.

Although section 481 appears innocent enough on its face, careful analysis of the section reveals that it produces at least three undesirable results:

(1) It has the effect of reopening taxable years now barred by the statute of limitations.

(2) It causes gross distortions in taxable income by attributing income to the wrong year, thereby violating the concept of annual accounting of income.

(3) It provides for the correction of errors occurring at any time since February 28, 1913, and creates a startling exception to a long-established policy against a retroactive increase of tax liability.

A simple example will illustrate how section 481 would produce these undesirable results. A taxpayer began a small retail furniture business in a rural community in 1935. Most of his sales were credit sales. In filing his income tax return for 1935 and subsequent years, he erroneously but in good faith failed to accrue accounts receivable. At the end of 1935 his receivables amounted to $10,000, and thus his taxable income under a correct accrual method of accounting was understated for 1935 in the amount of $10,000. His business has gradually grown and for each year through 1947 his receivables at the end of the year have exceeded those at the beginning by $10,000 so that at the close of 1947 the receivables amounted to $130,000. For 1948 through 1953, receivables remained stable. Assume that at the end of 1954 they are reduced to $120,000.

Under these facts, income was understated by $10,000 per year from 1935 through 1947. Income was correctly reported for the years 1948 through 1953 and in 1954 it was overstated by the amount of $10,000.

The Commissioner is now barred by the statute of limitations from collecting any tax deficiencies for the years 1935 through 1947. Assume further, as has frequently happened in these cases, that a deputy collector in 1946 checked and approved the returns for 1943, 1944, and 1945.

Under the proposed section 481, the Commissioner would be authorized in this case arbitrarily to increase the taxpayer's income in 1954 by the amount of $120,000 (the amount of the opening accounts receivable less the $10,000 overstatement of income in 1954). The resulting tax deficiency could not, under the proposal, exceed the deficiency which would result if $40,000 were added to taxable income in each of the 3 years 1952, 1953, and 1954.

For the relatively few taxpayers affected by the proposed section 481, these facts are not unusual. These taxpayers are on the whole small businesses that have had a gradual growth over the past decade or two. They had no competent accounting representation and, if investigated at all, the investigating agents, either on field investigation or office audit, have not bothered to change their accounting methods. Such businesses will be found largely in rural areas where farmers generally file returns on a cash basis despite the existence of inventories and accounts receivable.

In recent years the Commissioner of Internal Revenue has become stricter in enforcing the requirements of the regulations regarding accounting methods. In requiring taxpayers to correct their accounting methods, he has attempted to make "adjustments" which in effect tax in an "open" year all of the unreported income resulting from the use of the erroneous method in prior years barred by the statute of limitations.

The courts have properly held that the Commissioner's so-called "adjustment's" amount simply to a reopening of the statute of limitations. *Welp* v. *U. S.* (201 F. (2), 128 (C. A. 8, 1953)); *Commissioner* v. *Dwyer* (203 F. (2) 522 (C. A. 2. 1953)); *Davis W. Hughes* (22 TC —, No. 1 (Apr. 7, 1954)). These cases reaffirmed the principle that "income accrued in 1 tax year may not be taxed in another."

Section 481 would permit the Commissioner to do what the courts have prevented him from doing, namely, to compel the taxpayer to change a long used method of accounting and then by "adjustments" to accumulate in a current year the errors of years long barred by the statute of limitations.

This section would create income where none exists. It would financially embarrass and ruin many of the taxpayers affected because they cannot afford

in a 3-year period to pay taxes on fictitious income equal in amount to their accounts receivable or their inventories, or both. Many of these businesses are already hard pressed to finance their present inventories and receivables.

PROPOSED SECTION 481 VIOLATES ANNUAL ACCOUNTING CONCEPT

Section 481 violates an important principle of income-tax law, the concept of the annual accounting period. The adjustments which the Commissioner wishes permission to force upon the taxpayer are not necessary in order clearly to reflect income for the year of change or for any year thereafter. They represent an attempt to correct, in the year of change, for the results of past accounting errors. The section makes taxable income determinable with reference to all time since February 28, 1913, rather than upon an annual basis.

It cannot be disputed that to allow the Commissioner to make the adjustments called for under section 481 would result in the determination of taxable income for the year of change on an accounting basis which does not conform to any acceptable method. For example, if a small groceryman had erroneously filed his returns for 10 years, or even for 40 years, on a cash basis, the Commissioner in changing him to an accrual basis in 1954 would distort 1954 income in the 2 principal respects, namely:

(1) All receipts in 1954 would be added to his year-end accounts receivable in computing gross income, and thus, on either an accrual or cash method, gross receipt would be distorted by this overstatement; and

(2) "Costs of goods sold" would be reduced by the amount of the closing inventory but would not be increased by the amount of the opening inventory, and thus, on either an accrual or cash method, "cost of goods sold" would be distorted by this understatement.

This involves for these cases a complete abandonment of the concept of an annual accounting for the year's income.

A FORCED CHANGE OF ACCOUNTING IS NOT COMPARABLE TO A PERMISSIVE CHANGE

It has been suggested that the proposal incorporated in section 481 is reasonable because similar adjustments would be required if the taxpayer requested permission to change his method of accounting. This thought is incorporated in the report of the Ways and Means Committee (H. R. 1337, 83d Cong., 2d sess., p. 50).

It is submitted that the making of transitional adjustments where a taxpayer requests permission to change his method of accounting is entirely different from compelling "adjustments" where the Commissioner requires a change in the method on the ground that returns have been erroneous in past years, including years now barred by the statute of limitations. The Commissioner has the discretion to deny a taxpayer's request to change an existing method of accounting and to attach conditions to his grant of permission. Where a taxpayer has filed his returns for a period of years on a particular method of accounting, and where these returns have been accepted by the Commissioner without correction, the taxpayer should not then be permitted to change his method of accounting to his advantage and to the disadvantage of the Commissioner. The right of the Commissioner to attach conditions to a change of accounting method requested by the taxpayer is entirely consistent with the provisions of section 3801 of the Internal Revenue Code of 1939, as amended, which provisions are incorporated without substantial change in sections 1311 to 1314 of the proposed Internal Revenue Code of 1954. The fundamental principle of section 3801 is that neither the taxpayer nor the Commissioner should be permitted to take advantage of the statute of limitations by maintaining a position on a particular item in an "open" year which is inconsistent with a position taken on the item in a "closed" year. The party urging the change is not permitted to take advantage of the statute of limitations.

The proposed section 481 conflicts with the fundamental and underlying principle of section 3801 of the present code in that it permits the Commissioner to maintain an inconsistent position to the extreme disadvantage of the taxpayer. It permits the Commissioner, after accepting returns for past years on a basis which the Commissioner now considers unacceptable, to require the errors of past years to be corrected by putting the unreported income into the current year.

SECTION 481 RETROACTIVELY INCREASES TAX LIABILITY

For many years there has existed in Congress a strong policy against legislation increasing tax liabilities established for prior years.

Section 481 would constitute a startling exception to the policy against retroactive increase of a tax liability established under prior laws. It goes far beyond the mere retroactive correction of a past inequity suffered by a taxpayer as a result of an unintended application of the law. It is unprecedented in reopening the statute of limitations on innocent errors now barred. It provides for the correction of errors occurring at any time since February 28, 1913.

The fact that the "adjustments" authorized by section 481 are made by the Commissioner in a current year does not disguise the fact that the section would tax income which accrued in years now barred by the statute (*Welp* v. *U. S.*, and *Commissioner* v. *Dwyer*, *supra*).

SECTION 481 WOULD PRODUCE HARDSHIP

There can be no dispute that the result of the adjustments permitted by section 481 would be to distort the taxable income of the year of change. It is also obvious that the distortion would be at the taxpayer's expense. In other words, these adjustments would have the usual effect of pyramiding income in the year of change. The drafters of the section tacitly recognized this fact by attempting to soften the blow for the taxpayer somewhat by permitting the increased income attributable to the adjustments to be spread back evenly over a 3-year period.

If section 481 is to be enacted in its present form, it would undoubtedly cause great hardship. The burden would unfortunately fall on those least able to afford it. It is generally the small business which is unable to afford competent accounting and legal advice that fails to report income on an acceptable accounting basis. For example, there are many small businesses in rural communities, where the cash basis is so frequently used in farming operations, that have erroneously filed their returns on the cash basis or on a "hybrid" basis. I personally know of several instances where poultrymen and hatcherymen have done so on the ground that they come within the Treasury regulations in this regard covering farmers. Whether or not these returns were erroneous is still being contested. It has been estimated that a majority of the hatcherymen in the country have filed their returns on a cash basis and until recent years these returns have been accepted as filed. I know of another case where the proprietor of a smalltown furniture store, selling largely on credit, failed to accrue accounts receivable for approximately 20 years before the Commissioner raised any objection. He had prepared his own returns and got his advice on accounting from others in his trade, where this accounting method, I am told, is widely used by small furniture merchants in rural areas.

In these cases a taxpayer's entire net worth will often be reflected largely in his accounts receivable or his inventories. He will be unable to liquidate these and still stay in business, but he could not pay the taxes which section 481 would produce without a major liquidation. Business expansion by these small taxpayers would be barred and substantial liquidations required. As stated, the burdens from section 481 would fall heavily on many small taxpayers already pressed to finance inventories and accounts receivable.

SUGGESTIONS FOR IMPROVEMENT OF SECTION 481

I wish to suggest changes which seem to me in fairness to be required if section 481 were to be adopted.

(1) If such a change in law is to be made, section 481 should be amended to prevent the inclusion in current years of income which should have been reported in years which were barred at the time of the enactment of the bill. In other words, if the Commissioner forces a taxpayer to change his method for 1954, the Commissioner should not be permitted to adjust for amounts attributable to taxable years which are barred by the statute of limitations at the time H. R. 8300 is adopted. This would only recognize that it is not fair play to change the law retroactively to the great detriment of the taxpayer. At least, for the future, the taxpayer would have the advantage of being put on notice of the change in law. To effectuate the above proposal, we suggest the following amendment:

"That the present subsections (c) and (d) of section 481 be numbered (d) and (e) and that the following subsection (c) be inserted:

"(c) If the change of accounting method described in subsection (a) (1) is required by the Secretary or his delegate, the increase in taxable income for the

year of change which results solely by reason of the adjustments required by subsection (a) (2) shall not exceed the total amount of additional taxable income which would result if the new method of accounting were applied to the year of change and to each prior taxable year with respect to which an assessment of tax on the date of the enactment of this title was not barred by the running of the period of limitations for assessment."

This modification of section 481 would prevent the effective reopening of years barred by the statute of limitations.

(2) As urged above, there are serious objections in principle to any proposal to permit the Commissioner to increase income arbitrarily in current years to offset understatements in returns accepted, and in many cases approved after examination, in years now barred.

The accounting methods at which section 481 is directed do not avoid the reporting of income. Their usual effect is to postpone the reporting of income to the extent that accounts receivable, or inventories, or both, depending on the particular accounting method used, are increasing from year to year. These methods generally have the effect of postponing income during periods when a business is expanding. As compared with an accrual method, they report a greater income during a period when a business is contracting. These methods are not objectionable in themselves, but only insofar as they are used by particular taxpayers. Most of the farmers of the country file their returns on a cash basis, and many file on some hybrid method of accounting which combines features of the cash method and the accrual method. Farmers may have both inventories and accounts receivable and still be entitled to file on a cash basis. Most of the professional men of the country—doctors, lawyers, and the like—file on a cash basis, even though the method does result in the postponing of receipts while expenses are generally deducted currently. Many other businesses, having accounts receivable but no inventories, file on a cash basis. There is, therefore, no inherent objection against the continued use of a cash or hybrid method where it has been used in past years and returns have been accepted on that basis. In a fairly stable business, income will be correctly reported and, where the business contracts, greater amounts of income will be reported and taxed under the cash or hybrid method than under an accrual method.

It is recognized, however, that the Commissioner under present law does face somewhat of a dilemma in regard to a continually expanding business. After having accepted returns on a cash or hybrid basis for many years, he is faced with the dilemma of permitting the taxpayer to remain on the old basis and postpone income in years of future expansion or of forcing a change and thus under current decisions losing the right ever to tax income postponed from years now barred.

I submit, as a compromise, that it might be fair in these cases, where the Commissioner compels the change of a long-used accounting method, to provide that the old method be continued to the extent of the amount of the receivables and inventory on hand at the beginning of the first open year, and that the method urged by the Commissioner, which almost invariably will be the accrual method, be applied to any expansion of the inventory and accounts receivable. This would remove the Commissioner from his present dilemma and would not be unfair to the taxpayer because it would treat inventories and accounts receivable in a manner consistent with the treatment in barred years, to the extent of the amount involved in the barred years.

It is true that this compromise would involve some accounting complexities, but these would be small in relation to the severe and unfair financial burdens which section 481 as proposed would heap upon a taxpayer. Moreover, the additional accounting difficulties for the Commissioner would be relatively small compared to his problems that would thus be solved by removing the dilemma described above. It should be reiterated in this connection that the erroneous returns were accepted in past years, in some cases after investigation, so that the blame or fault is at least shared between the small, ill-advised taxpayer and an Internal Revenue Service which was fairly lenient with regard to accounting methods in earlier years and is now attempting to enforce stricter rules.

The accounting problems resulting from this particular solution are not particularly difficult or unusual. Inventories deducted in earlier years on a cash basis should, to the extent of their "dollar value," be carried at a zero cost basis on a last-in, first-out inventory method. The technique to be used is well known in the computation of inventories on a "lifo" basis. A new but similar technique could be used with respect to accounts receivable, so that any increase in the dollar amount of accounts receivable would be treated on an accrual basis

and any decrease in the dollar amount of accounts receivable would be treated in a manner consistent with the cash basis. The effect of these two adjustments would be to permit the taxpayer to remain on his present basis to the extent of his accounts receivable and inventories outstanding at the beginning of the first open year. Income from these particular items, and to the extent thereof, would be reflected as the business contracted. This would be consistent with the accounting method used in past years and would not financially embarrass or burden the taxpayer because as his inventories or accounts receivable are liquidated, or in other words reduced, he receives cash with which he is able to pay taxes on these amounts.

The broad purposes of this proposal could be incorporated in a revised section 481 in general language with the authority left to the Secretary to implement the section by regulation. Section 481 as presently drafted follows this procedure. If, however, the section cannot be satisfactorily redrafted within the limited time available, it should be eliminated entirely so that adequate time may be given in a compromise provision which is not as one sided as the present section 481 but which does attempt to compromise a difficult problem in a manner that does not impose harsh and severe financial burdens upon innocent taxpayers.

(3) There are other less consequential suggestions which I wish to submit with respect to section 481. The Commissioner under the present section apparently is not required to make the change to the new accounting method in the first open year but can make it in a current year, or wait for a future year. He can make it in the last open year rather than the first open year. For example, he could compel a change for the year 1954 even though all years from 1949 forward might be open on waiver. He could thus accumulate in 3 years income that under present law should be spread over the six open years.

Another proposal which could be incorporated in section 481 is that the taxpayer be given the option of correcting all of his prior returns, and, since the bar of the statute of limitations would be lifted for such prior years, no interest on any deficiencies or overpayments should be allowed either party for such years. This raises difficulties as to the correction of other errors not involved in accounting methods, as to the adequacy of records, and as to the making of elections which an advised taxpayer would have made at the time. As to the making of elections, for example, a well-advised retail furniture store operator at the time might well have elected an installment method if most of his sales were made on a credit basis.

As stated, the incorporation of these suggestions in a revision of section 481 would give a better balance to the present draft which does resolve a dilemma for the Commissioner but does it in a way which I submit is harsh, arbitrary, and completely unfair.

Respectfully submitted.

RANDOLPH W. THROWER,
Sutherland, Asbill & Brennan.

ATLANTA, GA.

SHOSHONE COCA-COLA BOTTLING CO.,
Reno, Nev., April 26, 1954.

HON. GEORGE W. MALONE,
Senator, State of Nevada,
Senate Building, Washington, D. C.

DEAR SENATOR MALONE: Thank you for your letter of March 11 in reply to my letter of March 5. My apologies for the delay in acknowledging your letter, but I have been out of town a great deal and have just returned.

Attached you will find a summary of my objections to the proposed change in the Internal Revenue Code, which would allow breweries to use their present machinery for the bottling of soft drinks.

I trust that when this measure comes before you that you will give it your attention, as it certainly does mean much to the small independently owned bottling plant which has been established to bottle only soft drinks.

I would appreciate hearing from you on the final disposition of this measure when it comes before your committee.

With every good wish, I am,

Sincerely yours,

L. CURTIS FARR.

With reference to the contemplated change in the Internal Revenue Code to allow breweries to use their bottling machinery for the bottling of soft drinks, I want to oppose this change for the following reasons:

Most breweries today are held by large companies or by individual groups or by giant holding companies that are engaged in the manufacture and distribution of other alcoholic beverages. Therefore breweries, in general, have at their command capital in large sums to spend for advertising, merchandising, and sales. Despite this, the brewery industry has long wanted to eliminate or cripple the soft-drink industry, as the soft-drink industry has proven a strong competitor in the sale of refreshment to the adult age group.

The largest percentage of the bottled-soft-drink plants are owned by individuals, who have all their capital invested in a small business established for the sole purpose of bottling soft drinks. Therefore soft-drink plants, in general, do not have at their command capital in large sums to spend for advertising, merchandising, and sales.

In the proposed change to the Internal Revenue Code it is stated that the breweries have many days during which they are not operating their expensive machinery; that by permitting them to bottle soft drinks on the same machinery, it would eliminate the high cost of overhead and, at the same time, allow them to realize some benefit from their expensive machinery.

The individual bottler of soft drinks has expensive machinery, too, and he also has many days during which his machinery is idle, and not realizing any income. But such a bottler has no solution to this problem as he is equipped to bottle only soft drinks. He must take the loss of idle machinery. In many cases, in order to take up the slack, and compensate in part for the loss of income from idle machinery, soft-drink plants have become distributors for breweries. Then, too, by taking such a distributorship it has enabled the soft-drink bottler to keep his employees employed full time.

By changing the code, it will permit the brewery industry to realize additional benefit from their machinery to the detriment of the individual bottler of soft drinks, who has no way of utilizing his idle machinery. It will penalize the individual bottler of soft drinks by permitting big competitors to enter his field and take his business, and in turn give him no solution to his problem of idle machinery. In other words, it is big business eliminating small business.

The code should not be relaxed or changed if the brewery industry wishes to enter the soft-drink industry. There is nothing to stop them from bottling soft drinks, by investing in another bottling plant, and machinery that will be used by them exclusively for the bottling of soft drinks. This, then, would put them on a par with the individual bottlers of soft drinks, with the same expenses and other items of operating costs.

In view of the above, I earnestly request that careful consideration be given to the small-business man who is in the bottling business and not allow the brewery industry to enter the soft-drink field as a side line to the bottling of beer. To do so will hurt and possibly destroy the small individual bottler of soft drinks. We realize that the brewery industry is feeling keen competition and that, with the growth of that competition, individual breweries are feeling the decrease in sales. But certainly by permitting the brewery industry to enter the soft-drink field you will be providing a solution for one industry and encouraging the destruction of many small bottlers of soft drinks.

Statement of Alvin H. Hansen, Professor of Political Economy, Harvard University, Cambridge, Mass., Re the 1954 Tax Program

I should like to address myself first to the problem of so-called double taxation. Is it correct to call it "double taxation," and is there convincing evidence that our corporate income tax in conjunction with the tax on dividend recipients is causing damage to the economy?

THE PROBLEM OF DOUBLE TAXATION

Consider first the question whether this is really double taxation. If it could be shown that the tax on corporate profits is not shifted and that it rests in fact on the corporation itself, then of course it would be double taxation. Economists are, however, I believe, more and more of the opinion that definitive conclusions are not possible. The trend of thinking seems to be toward the view that the corporate income tax, instead of being borne exclusively by the corporation, is in fact widely diffused throughout the price system. In large part the tax is shifted forward in higher prices to consumers and backward in

lower wages than could otherwise be paid to the wage earner. Some undefined residue, more or less, is borne by the corporation, the amount of this residue varying with the business cycle. In boom conditions, i. e., a sellers' market, the corporation is likely to be able to shift the whole or nearly the whole of the tax. Profits after taxes in such periods tend to be high. In depression periods, the profits decline, the tax take falls away, but such tax liability as remains is less likely to be shifted

Thus it is exactly when the corporate income tax take is high that the corporation is not likely to bear much of the tax burden.

If a sharp cut in the corporate income tax were made currently, it is clear that the trade-unions would not, if they could help it, permit the corporations to retain all the released excess earnings without staging a powerful drive for higher wages. By the same token, a high corporate income tax operates as a restraining influence on wages, since the corporations must struggle to retain enough earnings after taxes for expansion and indeed for survival.

I give herewith a table showing the course of profits before and after taxes in selected high employment years from 1929 to the present. As everyone knows, corporate incomes after taxes have been highly satisfactory, despite the greatly increased corporate income-tax rates. A commonsense interpretation of the figures indicates that the taxes were in fact for the most part widely diffused throughout the price-wage structure in a manner which throws serious doubt on the thesis that any large amount of the tax was borne by the corporation. To the extent that this is true, there is no double taxation.

TABLE—*Corporate profits and taxes*

[In billions]

	Corporate income taxes	Corporate profits before taxes	Corporate profits after taxes
1929	$1 4	$9 8	$8.4
1941	7.8	17.2	9 4
1947–49	11 9	30 5	18 5
1951–52	22.1	41.5	19.4

Let us assume, however, for the sake of the argument that the corporation does bear a considerable amount of the corporate income tax so that the stockholder is hit twice, first at the corporate level and then at the individual level. Assuming this to be the case, relief for such double taxation could be sought in various ways.

THE PROPOSED BILL IS DISCRIMINATORY

The proposed bill is one of several methods, and in my judgment not by any means the best one. Indeed I believe there are serious objections to it. The proposed bill is not equitable. It introduces a system of discrimination between different classes of personal income receivers. Compare a stockholder who receives his entire income from dividends with a worker who receives his entire income from wages. Both men are assumed to have 3 dependents and both use the 10-percent deductions method. The worker earning a $4,000 wage income would pay $240 in Federal income taxes while the stockholder with the same income would pay less than half this amount. A stockholder with a $9,000 dividend income would pay less taxes than a wage or salary worker with $6,000 income.

This bill, if it becomes law, would discriminate grossly in favor of income from dividends to the disadvantage of wage or salary income. Earned income would be penalized while property income from stocks would be unjustly favored. In the State of Massachusetts, on the other hand, it is felt that discrimination in favor of earned income can socially be justified. In Massachusetts, earned income pays 2½ percent while income from dividends and interest pays 6 percent. In the proposed bill, however, we have exactly the reverse—earned income is penalized and dividend income is placed in a favored position.

I do not suggest that the Federal income tax should favor earned income. Indeed the Massachusetts law provides in effect a kind of rough progressivity in its income-tax structure since the dividend and interest recipients are for the most part upper-middle class or well-to-do persons. A scheduled progressive tax structure without discrimination is, however, to be preferred to the

Massachusetts system. The best rule is no discrimination. A classification of personal incomes designed to favor a special class such as stockholders is discriminatory and should not be tolerated.

OTHER METHODS OF PROVIDING RELIEF FOR DOUBLE TAXATION

Double taxation, if it is believed to be a serious problem, which I should doubt, could be taken care of by other methods. One method would be to apply the standard corporate tax rate on corporate profits less dividends and a lower corporate tax rate on the part that is distributed. For example, the corporation might pay 50 percent on the retained part and 40 percent on the distributed part of corporate earnings. But the stockholder would pay the same rate on his dividend income as any other income recipient.

Another way of providing relief would be simply to lower the corporate tax rate.

Still another method would be that proposed by the CED. The CED proposal is to be preferred to the proposed bill in the respect that the tax credit allowed is included in the taxable income of the stockholder just as is done in the case of the current withholding of wages at the source. The Treasury proposal is defective in the respect that the tax credit is not added back into income in the calculation of taxable income.

Under CED dividend relief proposal the taxpayer at all brackets of his income would get a net increase of 10 percent in his income after taxes. Under the proposed bill, however, the net percentage gain in income after taxes would rise progressively the higher the income bracket. In the highest brackets, the net increase in income after taxes would eventually reach 100 percent, compared with the 10-percent increase in the CED proposal. Thus the proposed bill favors stockholders in the upper income brackets in a highly discriminatory manner.

Under the proposed bill the imputed part of the stockholders income (namely, the 10 percent represented by his tax credit) pays no tax at all. If the principle embodied in the proposed bill were applied to the individual income tax generally, we should all be able to report our taxable income as income minus taxes withheld at the source. If this principle were applied generally, a very large amount of income would escape taxation altogether. By the same token, under the proposed bill, a considerable amount of dividend income escapes taxes altogether.

Whatever else is or is not done, this particular feature of the proposed bill should at any rate be changed. In conformity with the existing practice with respect to the individual income tax, taxable income from dividends should include the income actually received plus the 10-percent tax credit to stockholders which it is assumed has been withheld and paid by the corporation.

WILL THE PROPOSED BILL STIMULATE INVESTMENT?

We come now to the question, Would the proposed bill, if it became law, promote investment in business plant and equipment? In my judgment, it would have little if any noticeable effect It is true that, to a degree, it would tend to make stocks more desirable than now relative to bonds. The net effect would be to close a little the current wide gap between the dividend yield and interest rates. Theoretically, this should tend to make it a little more favorable for a corporation, seeking new funds in the capital market, to float stock issues instead of bond issues. In practice, however, it appears that the factors influencing the volume of stock issues in relation to bond issues are very complex and it is not possible to reach a simple or easy conclusion. The margin between dividend yields and interest rates is by no means determining. Thus, during the 6 years 1922–27, inclusive, the spread between dividend yields, and interest rates was much narrower than in recent years. Nevertheless, bond issues constituted around 75 percent in both periods. In the twenties our tax laws were highly favorable both to stockholders and to corporations, compared to the recent high rates. Nevertheless, the financing methods employed were substantially the same in the two periods. It is true that in 1928–29, stimulated by the highly inflated stock market boom of the late twenties, the ratio of stock issues to total issues rose to 45 and 62 percent respectively: but surely no one would favor a return to this kind of stimulus to common stock flotations.

Superficially the tendency to raise capital, by borrowing, looks like bad practice. What is forgotten is that a very large part of new plant and equipment is financed out of retained earnings. For this reason, the prevailing practice of

financing around 75 percent of the total new issues by borrowing does not mean that the corporate debt position is getting worse and worse. On the contrary, the ratio of corporate debt to corporate assets is lower now than in the twenties. This could not have happened had it not been true that retained earnings played an overwhelmingly important part in capital formation.

We have just considered the matter of so-called double taxation from the standpoint of the possible effect of the proposed tax relief on the financing policies of the corporation But what about the stockholder? Will he not be in a stronger position to supply funds to the capital market under the proposed tax law? The answer, of course, is that the proposed tax relief will place funds in the hands of stockholders who might possibly use them for investment. But it does not follow that expenditures on plant and equipment will therefore in fact be higher by this amount. The stockholder who enjoys a tax cut may be quite uncertain about the future trend of the market and he may wish to wait and see. He may therefore hold the extra funds as an idle balance awaiting a favorable turn in the market. Or he may repay debt at the bank. Neither of these actions will increase the aggregate demand for goods and services. Finally, he may buy securities already outstanding. This also may have no effect on total spending. The seller of the securities may be advised, as many currently are, to hold more of his assets in cash. It is a great oversimplification to assume that a tax relief for stockholders will automatically insure that funds thus released will be spent on new plant and equipment.

In a society such as ours with a high volume of retained earnings, with a large flow of current savings flowing to financial institutions, with a large volume of liquid asset holdings by corporations and individuals, and finally with an elastic and responsive monetary and banking system, aggregate investment on plant and equipment is not appreciably limited by a shortage of investment funds. This is not the problem in a country like the United States, and it has not been a problem any time in recent years despite our high rate of taxation. The volume of expenditures on plant and equipment is rather determined by what businessmen regard as prudent investment taking account of cost-reducing improvements and the probable market for their products Availability of investment funds is not a significant limiting factor in a country like the United States. It is true that small and growing concerns are handicapped more or less in their access to investment funds. Here guaranty and insurance arrangements might be devised to alleviate this situation. But the problem should be attacked directly. It is not probable that the proposed bill is an answer to the problem of adequate financing for small and growing companies.

SHOULD WE NOW STIMULATE CONSUMPTION?

The proposed tax relief for stockholders cannot, I think, be realistically regarded as a significant factor tending to raise the level of capital investment in producers' plant and equipment.

Next I should like to consider the question: At this time should tax relief be designed to stimulate investment, or should it be designed to raise consumption? Under existing circumstances, it seems clear to me that stimulus to consumption is the correct policy. At any rate, I have seen nothing that seems to be at all convincing on the other side. Indeed under prevailing conditions it would seem to me that the best way to stimulate investment is to stimulate consumption.

We have been building plant and equipment at a very high rate ever since the end of the Second World War. During the last 8 years we have invested $240 billion in new producers' capital—in manufacturing, mining, transportation, public utilities, agriculture, and other business ventures. The current level of investment is $38 billion per year, or $28.4 billion if agriculture and outlays charged to current account are excluded. We have been catching up on the backlog of capital requirements created by the forced wartime curtailment of private investment outlays. This new equipment represents the most modern and improved techniques. Of late we have been developing excess capacity in some lines. The recent annual capital outlays have been running at a level considerably above normal. They have been high enough not only to take care of new technological development and the normal growth requirements, but also to make good the accumulated shortages caused by the war. The recent rate of capital formation is clearly higher than the long-run maintainable rate. It is not financially prudent to build more plant and equipment than we can profitably employ. Once the most modern techniques have been installed and some degree of excess capacity becomes more or less the general

rule, then the volume of new capital formation must settle down to a more moderate rate—a rate lower than the one we have had during the catching up period but high enough adequately to take care of new techniques and the continued growth of the economy. But it is surely unwise recklessly to go on adding more and more plant and equipment without regard to an appropriate balance between capital stock and consumption. There is a danger in artificially overstimulating capital formation in producers' plant and equipment without regard to the problem of final demand.

What we need now, as I see it, is more housing, more schools and hospitals and other much needed community facilities, and also more private consumption. If these areas are stimulated, there will be less danger of running into excess capacity of producers' capital. We can, however, create a new demand for producers' plant and equipment by raising the level of expenditures on housing, public construction, and private consumption. This seems to me to make sense, and it is, I think, good economics.

I conclude therefore that it is sound public policy at this time to stimulate private consumption by means of a tax cut. The recent cuts in excises are a step in the right direction. But this is not enough. It appears that it will be necessary, if we are to recover maximum production and employment, to cut the individual income tax.

VARIOUS METHODS TO CUT INCOME TAXES AND INCREASE CONSUMPTION

There are various ways in which consumption can be stimulated by a reduction in individual income taxes. In particular, the three main approaches that have been suggested may be briefly summarized as follows:

(*a*) Allow a fixed tax credit per dependent. This would be a flat per capita reduction for each taxpayer and dependent regardless of the income status of the taxpayer. In other words, the absolute amount of the tax credit would be the same to each taxpayer having the same number of dependents without regard to his income status. Obviously, the practical effect under this method would be to give almost all the tax relief to the lower income classes For each dollar lost by the Government, it would provide the maximum stimulus to consumption.

(*b*) A second method would be to increase personal exemptions. This would give somewhat larger absolute tax relief to higher incomes than would be the case with the first method discussed above. Nevertheless, the bulk of the tax relief would flow to the lower income classes. This method, therefore, would be almost equally potent to increase consumption

(*c*) A third method would be to cut the rate on the first $500 (or perhaps the first $1,000) of taxable income to 10 percent. A fourth variant would be some combination of (*b*) and (*c*) as suggested in earlier hearings before this committee.

Each of the following tax cuts means a reduction in tax revenues of about $2¼ billion: (1) A $20 credit per dependent, (2) an increase of $100 in personal exemptions (raising exemptions to $700), (3) a cut in the tax rate of the first $500 of taxable income to 10 percent. An increase of personal exemptions to $700 combined with a cut to 10 percent in the tax rate in the first $500 of taxable income would mean an aggregate reduction of about $4½ billion.

AT CURRENT CONSUMER PRICES EXEMPTIONS ARE TOO LOW

Any one of the tax methods outlined above are more or less equally potent as means to stimulate consumption and to overcome the current recession. From the standpoint of structural reform of the tax system, however, there is something to be said in favor of raising personal exemptions to $700 or even to $800. Two considerations come to mind. The first consideration relates to the undoubted fact that the present exemption is abnormally low in terms of the current cost of living. In the act of May 1944 the exemption was fixed at $500. Since then the consumer price index has increased by more than 50 percent. In terms, therefore, of the 1944 standard, the exemption ought now to be set at say $750 if the cost of living is taken as a criterion. Another possible basis for comparison would be the average per capita income of individuals in 1944 in relation to the current per capita income. Today the average per capita income of individuals is 60 percent or more above the 1944 average. In order to place personal exemptions at the same ratio to per capita income as the ratio prevailing in 1944 we should have to raise exemptions to $800. This would seem to be a reasonable proposition. Thus in terms of the rise in the cost of living since 1944, exemptions should be raised to $750, and in terms of the current average per capita

money income, exemptions should be increased to $800. Taking account of both criteria, the $800 exemption would appear to be a reasonable figure. The $600 exemption adopted in April 1948 is an inadequate adjustment to the major changes that have occurred since 1944. There can be no doubt that the relative tax position of the lower bracket income taxpayers has worsened since 1944 by reason of the major changes to which I have referred.

A BROAD INCOME-TAX BASE

The percentage of income receivers subject to Federal income tax today would be as large at an $800 personal exemption as in 1944 at the $500 exemption. If $500 was a reasonable personal exemption in 1944, when we needed a very broad income-tax base to finance the war, then the present day equivalent in real terms, namely, $800, must be regarded as fair and reasonable. By lowering the exemptions during the Second World War we enormously broadened the tax base. Indeed the number of tax returns filed increased from 7.5 million in 1939 to 47 million in 1944. Today's monetary equivalent of the wartime exemptions is, as I have shown, $800. An adjustment to this level would still give us as broad a tax base as we had during the war.

LOW INCOMES PAY HIGH TAXES

But there is another equally fundamental reason why $800 is not too high a figure. And the reason is this: Taking account of all taxes, Federal, State and local, a disproportionately high rate of taxes is paid by the lower-income groups in relation to income. The most authoritative study on progressivity in the entire tax structure, taking account of all taxes, direct and indirect, is that by Prof. R. A. Musgrave, of the University of Michigan. He shows that the lowest-income recipients (with incomes under $1,000) actually pay a higher proportion of income in taxes than those with incomes from $1,000 to $5,000 despite the fact that this lowest-income group would in many cases be entirely exempt from Federal income taxes . Indeed when all the indirect taxes are taken account of, this group pays 23.6 percent of their income in taxes, while those with incomes from $1,000 to $5,000 pay on the average less, namely, 21.3 percent of income. Even the $5,000 to $7,500 class pays a slightly smaller percent of income in taxes—the figure is 23.1 percent—than the class with less than $1,000 of income. Thus our entire tax structure, Federal, State and local, does not really begin to become progressive until the income level of $7,500 is reached In terms of an equitable prograssive-tax structure, taking account of all taxes, the tax burden on incomes below $4,000 is too high. An $800 exemption would give us a more equitable total tax structure.

It would be a great mistake, in our Federal system, to judge the tax structure merely in terms of the Federal income tax alone. It is not true that the families which would be taken off the Federal income-tax rolls by raising the exemptions to $800 would pay no taxes. They would indeed still be carrying a disproportionate load in terms of an equitable progressive tax structure.

Nor is it true that the general mass of consumers are quite unconscious of the indirect taxes which they pay. I suggest that people are quite alive to the fact that they pay gasoline taxes, tobacco taxes, entertainment taxes, personal-property taxes, and even taxes on rented residential property since the landlord is not likely to let renters forget that the rent must cover the property taxes. It is, I think, an error to argue that families at the lower-income scale would not pay their fair share of the total tax burden if we adopted the $800 exemption level.

An $800 exemption today would give us approximately the same number of taxpayers in relation to population as the $500 base did in 1944. In the event of a serious deterioration in the international situation requiring enlarged military expenditures, the $800 exemption would give us about the same number of taxpayers, in other words, as broad a tax base as we had in the Second World War. The tax base in real terms would in fact be much greater since average per capita income in real terms is much higher now than in 1942–45.

To sum up I conclude that an increase of exemptions to $800 is realistic and justifiable (1) because the rise in cost of living indicates an adjustment in personal exemptions, and (2) because per capita money incomes are now much higher, and exemptions should bear a reasonable relation to the level of money incomes. The tax structure would become increasingly regressive if exemptions were not adjusted to major changes in the cost of living, or were not raised to keep step with increases in per capita money income.

CYCLICAL CHANGES IN FIRST BRACKET RATES

For myself, however, I should not wish to go beyond the $800 exemption figure. If more consumer tax relief is necessary in order to promote maximum employment and production, I should want to turn next to a cut in rates, and not to further increases in exemptions. My reasons are as follows: First, I should want to retain as broad a tax base as is consistent with a fair and equitable progressive tax structure taking account of all taxes, direct and indirect. Confronted with realities which cannot quickly be changed, low exemptions in the Federal income tax make our aggregate tax structure unduly regressive. On the other hand, however, I should wish to retain as broad a Federal income-tax base as is reasonable in view of the considerations to which I have referred. The Federal income should remain the core of our tax structure, and as such it should have a broad base upon which to operate.

My second reason for turning next to rate cuts rather than further increases in exemptions beyond the $800 level is that exemptions should, as I see it, be set in terms of long-run considerations of equity and fairness to the lower-income groups. Exemptions should be changed only as the cost of living changes or as per capita money incomes change. But rates can and should be changed cyclically according to the requirements of continuing economic stability. Rates should be lowered when employment and production are falling, and rates should be increased when necessary to restrain inflationary tendencies.

Here the question will certainly be raised if there is not danger of going too far. The answer is to be found, I think, in the President's Economic Report. The report wisely counsels that the Government must be prepared to reverse itself if it finds it has gone too far. Unless we are prepared to do this, we shall never dare to act promptly and effectively.

HIGHER CONSUMPTION OR MORE RECESSION

An increase in disposable income is the surest and quickest way, I think, to increase consumer spending. If personal income after taxes (i. e., disposable income) is raised by, say, $4 billion or $5 billion, the net effect of the increased spending will be to raise aggregate income of the country as a whole by considerably more than this amount. A part of the increased spending will flow to business in higher profits, a part to Government in high tax revenues, and a part to currently unemployed wage earners. Thus, the process of spending the released tax money causes a further increase in income beyond the initial increase due to the tax cut. Experience shows that an initial and sustained boost to disposable income of $4 billion or $5 billion may raise aggregate income by perhaps double this amount after taking account of the secondary or induced effects.

Federal Government spending is down this year by around $3 billion, and current plans appear to indicate a further decline by $5 billion to $6 billion next year If this were all that had to be offset in order to maintain full employment, the problem would be relatively easy But this is not the case. Gains in productivity are fairly steadily being made each year, and this means that the same output can be produced with fewer and fewer workers. Around 1.2 million workers are displaced each year by technological progress. In addition, about 700,000 additional workers enter the labor market over and above the older workers who are leaving the labor market each year. Thus, if we should simply hold our own, maintaining a gross national product equal to our "second best year"—a phrase which is now becoming popular—we should be adding nearly 2 million to the ranks of the unemployed each year. Because of these growth factors in our economy, we have to add from $12 billion to $15 billion to our GNP each year in order to maintain maximum employment and production. Our problem is, therefore, not merely to offset the decline in Federal spending, but much more to take up the growth slack.

Now where can we look for expansion? I do not believe it is realistic to expect capital outlays on plant and equipment either this year or next to exceed the extraordinary high levels reached in recent years. As far as I know no one has suggested that such an increase is likely to occur. The reasons for this are obvious. Outlays on plant and equipment have been stimulated to very high levels since 1950 by the vast military buildup and by the 5-year amortization program. We are now over this hump. This artificial stimulus is now diminishing. Moreover, the accumulated backlog of capital requirements bequeathed by the war-created shortages have by now been filled or largely so Even with the stimulus of accelerated depreciation as proposed in the current

tax bill, we could scarcely hope to maintain, and certainly not to exceed, the recent high levels of investment in plant and equipment. The offsets to the decline in Federal spending must be sought elsewhere. Housing and public construction could be greatly expanded, but I find, I regret to say, altogether too little support for a program much beyond the levels reached in these areas in the recent past There remains then only consumption. And as far as I can see, consumption would need to increase $15 to $20 billion or so if we are to approach maximum production and employment.

Expansion tends to feed on itself just as contraction tends to feed on itself. If we can get expansion of employment and income going again, that in turn stimulates further expansion. Aggregate wages will rise, not merely from growing employment but also from higher wage rates in line with rising per worker productivity.

In a growing economy aggregate expenditures must increase from year to year beyond each year's earned income level. An expanding GNP must be fed from credit expansion, both public and private.

If a recession is allowed to deepen, a deficit is inevitable. A sharp fall in national income will automatically result in an increase in the public debt. And if an attempt is made to balance the budget, either by cutting expenditures or raising taxes, or both, income will be driven down still further. In these circumstances, the ratio of debt to national income will be worsened. If, however, bold steps are taken to bring about recovery, the debt will inded rise, but income will also rise. Thus a positive program of expansion will not only provide more employment and rising living standards, but also a more favorable ratio of debt to national income than could possibly be the case if a recession were allowed to develop.

Our goal is an expanding and balanced economy. The guiding principle of fiscal policy should be to balance loan financing with tax financing so as to prevent both inflation and deflation and to promote our full productive potential.

PRESENTATION TO THE COMMITTEE BY CHARLES B. JOHNSON, AS THE ATTORNEY OF FOURCO GLASS CO., ROLLAND GLASS CO, ADAMSTON FLAT GLASS CO., AND HARDING GLASS CO, ENGAGED IN THE MANUFACTURE AND MARKETING OF FLAT GLASS PRODUCTS IN THE UNITED STATES

MAY 4, 1954.

To the Honorable Eugene D Millikin, Chairman and the Members of the Committee on Finance of the United States Senate:

GENTLEMEN: This statement relates to subchapter C, Corporate Distributions and Adjustments of H. R. 8300, and especially to the amount of income includible in, and the recognition of gain or loss the result of, statutory mergers or consolidations

In order to present the inherent dangers incident to any attempt to rebuild a comprehensive revenue code, and the effect thereof on the legitimate activities of corporations, pending consideration, I deem it necessary to state briefly certain facts, and to present conclusions therefrom

Fourco Glass Co Rolland Glass Co, Adamston Flat Glass Co., and Harding Glass Co. are West Virginia corporations now, and for many years last past have been, engaged in producing and marketing flat glass products consisting in great volume of window glass These companies will be referred to as Fourco, Rolland, Adamston, and Harding.

Rolland was organized as a corporation about 1905 by a few stockholders, and has since that time, with few interruptions, continuously engaged in the manufacture and marketing of flat glass at Clarksburg, W. Va In 1933 Rolland purchased control and now owns more than 83 percent of the capital stock of Adamston which was then engaged in the like business, the two factories being within almost a stone's throw of each other. Adamston has been since the above date, with few interruptions, continuously engaged in the production and marketing of flat glass.

About 1935 Fourco was organized as a selling agency of not only the products of Rolland and Adamston, but of another independent glass company Later Fourco, whose stock is now owned in equal parts by Roland and Adamston, purchased all of the capital stock of Harding, with its plant at Fort Smith, Ark. Harding has been, since such acquirement, engaged, with few interruptions, in the manufacture and marketing of flat glass products. The three manufacturing plants have employed the same process of manufacture, have regularly

employed, and do now employ, substantially 1,500 persons, and have combined assets, together with Fourco, of substantially $9 million. Their debts are only those incident to operation expenditures.

The stocks of these corporations are not listed on any exchange. Rolland has now 28 shareholders and Adamston has now 25 shareholders. All of these companies, excepting Rolland, have outstanding common stock of the par value of $100. Rolland has common stock of the like par value and preferred stock of $50 par value.

In 1953 the managing officers and larger stockholders embarked on a plan of either the consolidation of all of these corporations into one, or, as finally adopted, the merger of Adamston with and into Rolland, and the absorption later of Fourco and Harding into Rolland. Plans of merger or consolidation require from 6 months to 1 year for accomplishment, largely because of the preparation of accurate balance sheets, the fixing of values, the necessity of a certificate from the Treasury Department that gain or loss will not result, and the necessity of compliance with time elements of the State statutes regulating mergers and consolidations.

In October 1953, a form of merger agreement, of Adamston into Rolland, together with supporting facts usually required, were presented to the Internal Revenue Department, the acting chief of reorganizations and dividend branch thereof then being Frances B Rapp, to procure the usual certificate that the proposed merger would result in no taxable gain or deductible loss under the provisions of the code of 1939, and especially section 112 (g) (1) (A). On December 21, 1953, the usual certificate was issued freeing the same, except for cash to be paid for partial shares, from taxable gain or deductible loss The merger agreement was then executed by a majority of the directors of Rolland and Adamston, on January 19, 1954. Thereafter notices were given of a meeting of the stockholders of each corporation to be held separately to adopt or reject the executed merger agreement. After compliance as to notice and publication thereof, stockholders meetings were held on March 30, 1954, and the merger agreement was adopted by each company.

A few days before March 30, 1954, H. R 8300 was passed by the House, which did, in some particulars, change the code of 1939 under which the Department issued the certificate of no gain or deductible loss as the result of the merger. In my judgment the certificate, given in good faith, would be nullified by the provisions of H. R. 8300.

At the time of the passage of H R. 8300 a statement was made by the Honorable David A. Reed, chairman of the House Ways and Means Committee, as follows.

"Some questions have been raised concerning the effective date of certain provisions in subchapter C of chapter 1 of subtitle A of H. R. 8300, relating to corporate distributions and adjustments.

"It was not our intention in H. R. 8300 to prevent transactions which qualify as reorganizations within the definition in section 112 (g) (1) of the Internal Revenue Code of 1939 from being carried out tax free where a resolution adopted by the shareholders or board of directors on or before March 9, 1954."

Under the applicable provision of H. R. 8300, now being considered by the Senate, for the purpose of determining whatever gain or loss shall result from mergers or consolidations, corporations are classified as publicly held or closely held, sections 354 (b) and 359. Neither Adamston nor Rolland is a publicly held corporation under these provisions Fewer than 10 shareholders own, in each company, more than 50 percent of the stock. The implication, if not the direct purpose, of that classification, is to deny to all corporations, other than publicly held corporations, the protection theretofore extended to all corporations from gain or deductible loss the result of merger, unless from such mergers there result a stock-ownership situation described in section 359 (c). In turn, section 359 (c) is subject to the provisions of (c) (2), and this, in turn, is modified by section 311.

The effective date of that provision, and all those provisions related for the purpose of ascertaining gain or loss, apparently was intended to be March 9, 1954. The result of that effective date, if the Senate should approve, might be construed to deny not only to Rolland and Adamston, but to deny to many other properly and legitimately organized and conducted corporations, mergers, or consolidations which are, in many instances, so necessary to efficiency in management and economical operation, or in anywise desirable for legitimate purposes.

Rolland, Adamston, and also Fourco and Harding, are corporations of long standing, well financed and of demonstrated ability to earn a profit; each is solvent; and the merger plan carried no purpose to evade the law or procure undue advantage in income liability under the Revenue Code of 1939. The sole purpose is to secure the most efficient management and economical operation so necessary in this present day of demonstrated home and foreign competition in the flat-glass business. At this time competitive flat glass is being supplied in ever increasing volume from Japan, Belgium, France, and other foreign countries, where conditions are such that glass made in those countries can be marketed, and are now being marketed in large volume, in the United States for less than the cost of the like glass in this country by those producing the same.

If a change is to be made in the law relating to gain or deductible loss the result of mergers and consolidations, it certainly seems reasonable, that those corporations which are, pending enactment of the new Revenue Code, acting in good faith, should have protection against an effective date which would destroy the work of a year; nullify certificates already granted by the Revenue Department; and in fact deny that plan of efficient and economical management so necessary to existence.

Certain sections of the code of 1954 relating to corporate organizations, acquisitions, and separations, and especially sections 354 and 359, are in part an endeavor to correct well-known evils resulting from simulated, as distinguished from honest and normal, business activities of corporations, in mergers and acquisitions of independent, allied, or competitive companies. It is difficult to understand how these evils may be corrected by a general classification of corporations in those where less than 10 shareholders own more than 50 percent of the outstanding stock, and so-called publicly held corporations, or by basing legitimacy upon percentage of stockholdings resulting from the merger. The normality of corporate acts have no relation to, and should not be determined by, the number of shareholders. It is well known that with most corporations a few shareholders, whether they be corporations having more than a million shareholders, or corporations with but a few shareholders, actually control the policies of the company. The evils sought to be cured are to be found in both publicly held corporations with many shareholders and in corporations with but few shareholders The remedy should be by direct attack, and should not be so applied as to condemn and inflict punishment on all corporations where the stock is not publicly held, or the validity is based on resultant percentages of ownership. I think it may be safely asserted that a few people still have the right, through the medium of a corporate organization, to engage in business, without a penalty because the public is not invited to participate in their profits the result of their skill and toilsome management, or because any acquisition of property, by merger, consolidation, or otherwise, does not result in a fixed formula of stock ownership after acquisition.

The immoral attempt to classify corporations, to the detriment of those having but a few shareholders, amounts to a discrimination which may be unlawful. The morality, righteousness, and the acts of a corporation should not be determined by the number of shareholders or the provisions of section 359 of the new code.

No doubt there were in course of accomplishment, or if not in course of accomplishment, then in contemplation, at the time of the enactment by the House of the Revenue Code of 1954, many mergers and consolidations which could not have been open to the charge of simulated or perverted purposes or not in the public interest. Ours was one. The good and necessary and lawful purposes of all these were frozen by the uncertain dangers of an imposed and deterring tax liability. Doubts will continue long after enactment.

The new code has not yet been adopted and what the provisions ultimately will be one cannot know. This situation points to one remedy.

The provisions of the Revenue Code of 1954, subchapter C, relating to corporate distributions and adjustments, in whatever form it may ultimately be, should be made effective so as not to disturb the orderly processes of business either in course of accomplishment or contemplation. After having read the learned discussion by Mr. J. S. Seidman, acting for American Institute of Accountants, I believe that if the code is to be enacted at this session the effective date of subchapter C, and specifically Part III—Corporate Organizations, Acquisitions, and Separations, so far as it relates to corporate distributions, acquisitions, and adjustments, should be deferred until, at the earliest, December 31, 1954.

That part thereof relating to the classification of corporations should be modified to serve the purpose intended, and to prevent the evil sought to be remedied, and not so as to discriminate against and condemn the legitimate acts of corporations solely on the basis of their number of shareholders, or the percentage of ownership of stock resulting from any such acquisition. A summary of the fiscal data relating to the plan of merger, the number of stockholders, the intercompany stockholdings, etc., is attached hereto as a part hereof.

The foregoing is submitted to those engaged in the laborious task of recodification, with that respect so justly due them for their studied efforts and with the confidence that these enumerated suggestions must be heeded to prevent gross wrong even though in principle not intended.

Respectfully submitted.

CHARLES B. JOHNSON,
Attorney for the Fourco group of companies listed above.

Facts as to the Rolland Glass Co. and Adamston Flat Glass Co. merger

1. FACTS AS TO COMMON STOCKHOLDERS

	Rolland	Adamston
Number of shares of common stock outstanding	9,600	4,440
Par value of all shares outstanding	$960,000	$444,000
Number of common shareholders	25	21
Number of shares of Adamston owned by Rolland Glass Co.		3,693
Number of shares of Adamston and Rolland owned by the Eugene Rolland Estate	5,180	55
Number of shares owned by 4 others owning stock in both companies	1,235	53
Number of Adamston shares owned by 19 persons owning no Rolland stock		639
Number of Rolland shares owned by 16 persons owning no Adamston stocks	3,185	
Total common shares	9,600	4,440

2. FACTS AS TO PREFERRED STOCKHOLDERS

Rolland Glass Co., has 27 preferred shareholders owning 5,760 shares of its $3 preferred, $50 par value, nonvoting; all but 4 of these shareholders own all the common stock of Rolland. The plan of merger contemplates no change in the preferred. These shares and holders thereof will remain the same.

3. FACTS AS TO DISTRIBUTION OF STOCK OF MERGED COMPANY

	Rolland	Adamston
Values used as a basis of dividing equities between the stockholders of both companies	$3,762,444.69	$3,134,402.31
Percentage of values of each company	45.4468876	55.5531124
Division of 140,400 new $10 par value shares to the stockholders of each company	76,592.57	63,807.43
Portion of shares representing Adamston's equity to go to Rolland's shareholders	53,072.51	(53,072.51)
Number of shares to be issued to Rolland shareholders	129,665.08	
Number of shares to be issued to Adamston minority shareholders		10,734.92

CONTROLLERS INSTITUTE OF AMERICA,
New York, N. Y., April 29, 1954.

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

DEAR SENATOR MILLIKIN: The National Committee on Federal Taxation of this institute has observed with satisfaction the favorable comments on H. R. 8300 which have been made by the principal groups which have appeared before you. We wish to endorse these comments. The bill is a stupendous document and this is a magnificent tribute to those who have so painstakingly rewritten, rearranged, revised, and expanded the 1939 code.

It is not possible that so enormous an undertaking as H. R. 8300 could be completed without its containing provisions which could be improved and omitting provisions which would be desirable additions. The recommendations which are attached to this letter doubtless include some which have already been brought to your attention and even some which have already been accepted.

We include them all in the belief that the record should state our position on those matters which appear to us to be of the greatest significance.

We do not believe that in the limited time which has been available we have necessarily discovered all items on which we might wish to comment. However, we believe that such matters, whenever they arise, will continue to receive the helpful and cooperative consideration of Mr. Stam and his staff.

Early in 1953 the national committee on Federal taxation of the Controllers Institute of America prepared and submitted a group of recommendations, some of which are incorporated in H. R. 8300. It has made recommendations in connection with corporate tax matters continuously for many years. The attached recommendations are the result of comments and suggestions received in response to invitations to the institute's 4,300 members. We regret that they are being presented so late, but the time has been short and the members of our committee have, of course, been particularly busy with the tax returns of their several companies.

Very truly yours,

WILFRED GODFREY,
Chairman, National Committee on Federal Taxation.

RECOMMENDATIONS WITH RESPECT TO H. R. 8300

(Controllers Institute of America, 1 East 42d Street, New York, N. Y.)

The following represents the recommendations of members of Controllers Institute, through its national committee on Federal taxation:

ACCOUNTING METHODS

Section 462 of H. R. 8300 provides that deductions may be taken for reserves in respect of certain estimated expenses. This is an important step toward the conforming of tax accounting to generally accepted accounting principles.

We believe that the section should state plainly that, in the year in which estimated expenses are first deducted, the actual losses of such year are also deductible. This conforms to the treatment of bad debts under existing law. A taxpayer who changes from the actual loss to the reserve method is allowed to deduct the provision for future losses as well as the actual losses.

LIFO INVENTORY METHOD

The law dealing with involuntary liquidation of inventories during the war years (1941–47) was designed to allow the costs of the year of liquidation to be charged with the replacement cost of such liquidated inventory rather than its inventory cost. This provision applied to replacements made before the end of 1950—extended to the end of 1952 by Public Law 919 (1951).

It was obviously assumed that taxpayers could be expected to make such replacements by the end of 1952 and, in particular, that replacement goods would be available. The facts have proved to be otherwise. Not only have taxpayers been unable in many instances to obtain goods to replace their wartime liquidations, but they have suffered further involuntary liquidations. Provision was made for certain of these later liquidations by Public Law 919 (1951), which allowed a similar adjustment for involuntary liquidations during 1950–53 as was originally allowed for wartime liquidations. This is extended to include 1954 by section 1321 of H. R. 8300. Adjustment for these years is conditioned on replacement being made before 1956.

At this point there existed three periods in which involuntary liquidation could occur—1941–47, 1948–49, and 1950–53. No adjustment was permitted in respect of liquidations in the middle period, 1948–49. Furthermore, as replacements made during 1951 and 1952 could have applied to involuntary liquidations in either the first or the last of the three periods, it was necessary to determine how replacements were to be applied. This was done by section 306 of the Revenue Act of 1951, which provided that involuntary liquidations during 1950–53 should be treated as having occurred prior to 1941–47 liquidations. This, added to the existing provision that replacements were to be deemed to apply to the most recent liquidations, resulted in the replacements during 1952–55 being applied to liquidations in this order—1948–49, 1941–47, and 1950–53.

It is desirable and proper that the right of replacement of wartime involuntary liquidations should be extended. The present emergency has prevented the replacement of many items. It is also desirable that replacements should be

applied to 1941–47 involuntary liquidations before liquidations occurring during 1948–49. Accordingly, we recommend that the replacement period for 1941-47 involuntary liquidations be extended at least through 1955, and that replacements be applied first to involuntary liquidations of the 1941–47 period and then to such liquidations of the current emergency period (1950–54).

A year in which involuntary liquidation takes place remains open, for tax purposes, until the year of replacement. We recommend that the income of the year of involuntary liquidation should be adjusted by the difference between the inventory cost and the current replacement cost of the liquidated items. The difference between such current cost and the replacement cost as determined in the year of actual replacement could be adjusted in such year. If replacement is not made the interim adjustment should be reversed in the last year in which replacement would have been recognized.

ACCRUAL OF REAL PROPERTY TAXES

The provisions of section 461 (c) represent a desirable step toward the determination of taxable income in accordance with generally accepted accounting principles. In making the new rule mandatory, however, this section creates a serious problem for taxpayers who have been keeping their books in accordance with existing law. The problem can best be illustrated by an example.

Assume that under present law a tax imposed for the calendar year 1954 has been deemed to accrue on November 1, 1953, its lien date. Under section 461 (c) (1), this tax would be deductible in 1954. Under the special rules provided in section 461 (c) (2), however, if the tax were allowable, as it is in this example, as a 1953 deduction under the 1939 code, the tax is not allowable as a 1954 deduction. This provision is apparently considered necessary to prevent the deduction of the same tax twice.

The taxpayer in this example is assumed to have been keeping his books in accordance with the present tax rule. To avoid distortion of financial operating results, he will undoubtedly wish to continue to accrue real property taxes for book purposes on the same basis, as otherwise his operations for the transition year would not include any charge for real-estate taxes. Section 461 (c) (2), however, would not permit a deduction in the transition year for the real-estate taxes which consistent accounting practice would require the taxpayer to accrue.

Section 461 (c) will be very helpful to taxpayers who have been keeping their books by the method contemplated in that section. Clearly, however, taxpayers who have been keeping their books on a basis consistent with present tax law should not be required to make a change. Section 461 (c) should be made elective rather than mandatory.

Another point which deserves consideration is the fact that section 461 (c) as written applies only to real-property taxes. There would seem to be no reason why the same principle should not be made applicable to personal-property taxes or any other taxes which relate to a definite period of time.

EMPLOYEE STOCK OPTIONS

The treatment of section 421 (a) (1), (2), and (3) should be extended, without reference to any of the percentage requirements or other restrictive rules found in section 421, to the broad type of employee stock option plans or stock purchase plans which are generally available on a nondiscriminatory basis in proportion to salary level to all employees meeting certain minimum service requirements. If any restrictions are attached, they should be along the lines of requiring that the stock be common stock, the value of the shares for which each employee is permitted to subscribe in any year be less than a percent (considered by Congress reasonable) of his total compensation from the employer, the total number of shares deliverable to employees in any year under the plan be less than a percent (considered by Congress reasonable) of the total number of shares of the offering corporation issued and outstanding at the beginning of such year, and the number of shares deliverable to any employee in any year under the plan be less than a percent (considered by Congress reasonable) of the total number of shares of the offering corporation issued and outstanding at the beginning of such year.

Under present economic and social conditions, the primary or even an incidental purpose of such stock purchase plans is not to provide additional compensation to employees but to interest employees generally in the management side of the business and to take advantage of an important and hitherto untapped source of equity capital. There is a rising concern over the shift in corporate

financing from equity to borrowed capital, and provisions of the sort suggested here will help to curb this shift. The universal application of unnecessarily restrictive rules to all stock option or stock purchase plans, regardless of the number of shares available to each employee or the amount of alleged compensation which may be derived in any case, merely serves to impede or prevent their use in circumstances where sound business judgment might otherwise dictate that they be adopted. The accounting burdens involved in applying a section like section 421 to a large plan make it virtually impossible to apply the section.

AFFILIATED GROUPS (EMPLOYEE BENEFITS)

Many plans cover more than one corporation and within a corporation may cover more than one group of employees having different coverages as required by union contracts or other agreements. Also union contracts may cover the employees of several affiliated companies. Because of long-standing methods of operation employees may be shifted between affiliated corporations because of changes in duties, or products, or business. In many instances it is impossible to determine actuarially the financial liability for pensions on an individual corporation basis. The liability for pensions may be decreased or increased several times for employees individually and by groups by changing laws and union contracts. These problems have been recognized by the Internal Revenue Bureau at various times. (See P. S. No. 14, 1944 P. H. par. 66, 352; special ruling, Oct. 23, 1944, 443 C. C. H., par. 6632; P. S. No. 51A, 1945 P. H. par. 76, 276; special ruling, 1945 P. H. par. 76, 281; special ruling, March 5, 1947 P. H. par. 76, 126; *Frederick J. Wolfe*, 8 T. C. 689 (1947); P. S. No. 62, 1950 P. H. par. 76, 285.)

Section 403 and 501 and the corresponding provisions of the present law seem to have been written without consideration of the problems involved in a plan covering more than one corporation and consolidated regulations do not refer to the issue. P. S. 51A makes an approach to the problem by allowing contributions to be made to a trust covering two or more corporations in relation to eligible payroll of employees covered by the trust but this solves only one small problem.

We recommend a revision of the bill providing where more than one corporation is covered by a plan or trust, or both, that the plan shall be considered as the plan of one employer for the various limitations contained in sections 403 and 501 unless by reasonable actuarial methods the various limitations can be applied on a separate corporation basis and that the taxpayer shall be allowed to choose whichever method suits his situation best.

In addition, the consolidated return provisions of chapter 6 should provide that deductions applicable to such plans shall be allowed on a consolidated basis in a manner similar to the treatment of contributions.

EMPLOYEES' PENSION, PROFIT-SHARING AND STOCK BONUS PLANS

In general, the provisions of the bill relating to pension, profit-sharing and stock bonus plans are designed to liberalize the existing tax treatment of such plans. With this general purpose we agree. However, there are certain amendments which should be made:

(1) The provisions of section 501 (e) (3), defining the permitted coverage of employees in approved plans, should be broadened to cover all classifications which are presently recognized under section 165 of the code. Otherwise many plans which have been set up meticulously to conform to the provisions of existing law will not qualify after the enactment of the bill.

(2) The provisions of section 501 (e) (4), relating to permissible contributions and benefits in the case of qualified plans, are defective since they do not recognize variations in contributions or benefits based on (*a*) years of credited service, and (*b*) employee contributions. They are also defective in that they recognize an exclusion of only a fixed figure ($4,000) in determining the ratio of benefits to compensation. While the principle of such an exclusion is proper, it should be stated in terms of the amount of compensation covered by social security so that plans which are geared specifically to social security can be adjusted automatically when social security is revised.

(3) The provisions of section 503, denying exemption for engaging in prohibited transactions, and the provisions of section 504 (a) (3), denying exemption for the prohibited use of accumulated income, should be made inapplicable to pension, profit-sharing, and stock-bonus plans since those areas are adequately

policed by the provisions of section 501 (e) (1) and (2) of the bill corresponding to section 165 (a) (1) and (2) of the present code. In any event, the provisions of section 503 should be made applicable only to transactions effected "after the date of enactment of this act" rather than after "March 1, 1954."

(4) The provisions of section 505, describing the allowable investments for certain exempt organizations, should not be made applicable to pension, profit-sharing, and stock-bonus plans and trusts since the restrictions in that section are unreasonable and outside the purview of the taxing authority.

(5) Section 2039 (c) of the bill provides for the exclusion from the estate of the value of certain annuities and other payments receivable by any beneficiary (but not the executor) of any deceased employee under employees' trusts or annuity contracts. It would seem that the value of such payments should be excluded even though they are made to the estate rather than directly to beneficiaries.

SICKNESS AND OTHER BENEFITS

For many years there has been a great deal of confusion in the application of rules relating to the tax status of payments to employees by or on behalf of employers representing sickness, accident, health, and other benefits. This condition has arisen largely by virtue of the very general terms of section 22 (b) (5) of the 1939 code and the fact that various interpretations of these provisions have been asserted. This situation does not appear to have been alleviated in any great degree in sections 104, 105, and 106 of the proposed bill. Our principal comments and suggestions as to each of these sections follow:

(1) In each of the sections 104, 105, and 106 the term "compensation for personal injuries or sickness" is used. Apparently with the intent that there shall be a distinction, the term "compensation for loss of wages" also appears in the identical context in section 105. It is difficult to conceive of many circumstances in which, in actual practice, these terms would be clearly mutually exclusive. In order to avoid further controversy and misinterpretation, it is suggested that the term "payment in connection with personal injuries or sickness" (or appropriate variant thereof, fully defined) be substituted throughout these sections for the two separate terms referred to above. If a single term cannot be used to accomplish the intended purpose, the separate terms used should be clearly defined and differentiated.

(2) As one of the conditions imposed for the qualification of an employer's accident or health plan, section 105 (c) (1) (D) requires that there shall be a waiting period, of unspecified duration, before the time when payments are to begin under the plan. Policy considerations may dictate that the tax benefit provided in section 105 should not be available for casual absence. It seems unrealistic, however, to impose this requirement as a condition for the qualification of a plan. It is suggested that this provision be omitted and that the same result, if deemed desirable, be obtained by providing that exclusion from gross income shall not be permitted until, say, starting with payments received for the third day of absence.

(NOTE.—Also on the matter of qualification see comments relating to section 501 (e) (4) (A) above.)

(3) A further comment concerning section 105 relates to the subsection (c) (2), Nonqualified Compensation. The provisions of this subsection are obscure and, in application, would seem to be at variance with the explanation and example of the intended operation of section 105 as contained at pages A33 and A34 of the report of the Committee on Ways and Means on H. R. 8300. Particularly if the suggestion in item (1) above to eliminate the term "compensation for loss of wages" is accepted, it should be possible to restate this definition in clearer terms. In any event, however, some restatement and clarification would appear to be required.

TAXATION OF INCOME FROM FOREIGN SOURCES

(1) The 14-percent credit for certain foreign income should be broadened and clarified.

(*a*) Income from branches engaged in specified permissible types of activities abroad should be accorded the credit without respect to exercising the privilege of deferring the tax on that income.

(*b*) Section 923 attempts to define the types of foreign business whose income will be eligible for the reduced rate. Although the committee report states that the objective is to give special tax treatment to significant investment

abroad, the objective is not consistently carried out in the section. Moreover, there are a great many difficult questions of interpretation. It is recommended, therefore, that both sections 923 and 951 substitute the simple requirement that 90 percent of the gross income from sources abroad be from "the active conduct of a trade or business through a permanent establishment located in a foreign country." The "permanent establishment" language is now used in all tax conventions.

(*c*) Disqualification in the event that 25 percent of gross income is derived from the sale of goods manufactured abroad and intended for use, consumption, or sale in the United States should be eliminated. The problem raises difficult questions of interpretation, and amounts to tariff legislation which has no place in a revenue act.

(*d*) The stock ownership test of foreign corporations should be reduced to 10 percent of the voting stock, in conformity with section 902 (a), relating to foreign tax credit.

(*e*) Section 923 should include royalties from patents, trade-marks, "know-how," and management fees from foreign sources. Such payments are the only means of withdrawing profits from many foreign countries. They should thus be treated in a similar manner to dividends.

(*f*) The taxable income limitation, which requires qualified income to be reduced by completely unrelated losses sustained in the operation of another branch or subsidiary in the same country, acts as a deterrent to foreign investment and should be eliminated.

(*g*) If a branch elects deferral, section 953 (d) requires that certain special adjustments be made in determining its net income. Among these are the denial of the 26-percent capital gain rate, and the elimination of deductions not allowed in determining income of a foreign corporation—such as percentage depletion. These adjustments should be eliminated.

(*h*) A Western Hemisphere trade corporation should be entitled to elect to defer its income under section 951, without giving up all preferential rate treatment upon its later withdrawal. Either the section 922 credit or the section 923 credit should be available. Which it is, should be made clear in the law.

(*i*) The committee report indicates that the loss of investment in an elected branch upon its liquidation, is not allowed as a deduction, and is not treated as a loss arising from the sale or exchange of a capital asset. It is also stated that an operating deficit of an elected branch is not allowed as a deduction. There is no apparent justification for the denial of these deductions, and it is therefore recommended that the losses specifically be allowed.

(2) Sections 902 and 903 fail altogether in their purpose to enlarge the foreign taxes allowable as a foreign tax credit. They should be amended to include a tax imposed wholly or partially in lieu of an income, war profits, or excess profits tax. In addition to an income, war profits, or excess profits tax, the foreign tax credit should include the foreign country's "principal taxes" (if they are not includible in the income, war profits, or excess profits tax). Finally, these provisions should be amended so that "principal tax" includes a tax which is generally imposed.

(3) It is recommended that section 921 be expanded to permit a Western Hemisphere trade corporation to make purchases incident to its business outside the Western Hemisphere.

DEPRECIATION

Section 167 of H. R. 8300 represents, within present budgetary limitations, a commendable step in the direction of liberalization of the depreciation allowance and reduction of the number of disputes in this area. The provisions of the bill are, however, still too restrictive and could be made more practicable without further significant loss of revenue.

While the section provides for a reasonable allowance it is believed that the effect of subsection (b) in its present form may well be to regard the allowances under the "declining balance method" as the maximum. It would seem desirable to provide that other methods (such as the "sum of the digits") may be used and that methods previously used (such as "units of production") may be adopted or continued.

Under the bill, depreciation under the declining balance method continues as long as a single asset of any particular year's acquisitions remains in service. If detailed records are not maintained with respect to each item acquired, declining balance depreciation continues literally to infinity.

This terminal writeoff problem could be met by various methods such as permitting the writeoff of any remaining undepreciated balance in last year of estimated useful life.

The 10 percent limitation with respect to the correction of taxpayers' estimates of useful life is designed to eliminate costly and time-consuming disputes concerning differences which have little or no effect on the revenue. Since factors such as obsolescence, which bear on the problem, differ greatly between taxpayers, and differ from year to year with each taxpayer, this limitation is so small as to render it largely ineffective in accomplishing the desired purpose of avoiding disputes. It is therefore recommended that this limitation be increased to at least 25 percent. If this is considered undesirable, subsection (e) should be eliminated entirely.

Since depreciation normally starts when a building or other structure is completed and placed into service, it is suggested that, in the case of property, construction of which is completed after December 31, 1953, which did not become subject to depreciation before that date, the declining balance method be permitted with respect to the entire cost of the property.

The committee report (third paragraph, p. A50) might be interpreted to mean that the taxpayer would be permitted to use the declining balance or other acceptable method of computing depreciation only if he computed depreciation under such method for the first taxable year ending after December 31, 1953. There would seem to be no valid reason why a taxpayer should not be permitted to adopt the declining balance or other acceptable method in any year as long as the method is applied only to assets acquired in such year or subsequent years.

CONSOLIDATED RETURNS

In codifying into statutory law the existing consolidated-returns regulations, a number of changes are made, most of them extremely harmful, particularly to corporations that have filed or expect to file consolidated returns for 1953. They certainly do not "remove inequities," "end harassment of the taxpayer," or "reduce tax barriers to * * * production and employment." (See p. 1 of House report.)

The new provisions effectively freeze present affiliated groups into consolidated returns, on top of which they make them add 80-percent subsidiaries and continue indefinitely Western Hemisphere trade corporations. They are frozen for the following reasons:

(1) Under section 1505 (a) (2), a reversion to separate returns is permitted as a result of a change in the law only if such change is of a "character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns."

(2) Such change, regardless of its effective date, must occur after the election to file a consolidated return. Because of this restriction, according to the committee report, a calendar-year group faced with a change in the law in 1954 (such as the 1954 code itself) affecting only 1954 and subsequent years, would have to break consolidation for 1953 in order to file a separate return for 1954, if its 1953 return is not filed until after the new law is enacted. We doubt whether the bill supports this view insofar as 1954 is concerned, but it would certainly be the result for subsequent years.

(3) It is still necessary in many cases to pay a tax a second time on intercompany profits in inventory as a penalty for breaking consolidation, because of the company by company and the separate return period limitations of section 1708 (c).

Until such time as the 2-percent penalty can be removed, we propose that:

(*a*) The taxpayer have the option to exclude less than 95-percent owned and Western Hemisphere trade and other foreign-trade subsidiaries.

(*b*) The privilege of breaking consolidation be allowed every year. Failing this, it should be provided that consolidation may be broken for any year affected by a change in the law or regulations disadvantageous to an affiliated group or any of the members thereof.

In addition we recommend that, upon breaking consolidation, the opening inventory of the various affiliates for the first nonconsolidated year be adjusted only to the extent that intercompany profits in inventory of the group as a whole have increased over the consolidaetd return period and that the separate return period limitation be eliminated.

CONSOLIDATED RETURNS— 2-PERCENT PENALTY TAX

The privilege of filing consolidated income-tax returns by an affiliated group of corporations was restored by Congress in the Revenue Act of 1942. In the Second Revenue Act of 1940, consolidated excess-profits-tax returns were authorized. In so doing, Congress recognized the identity of interest between a parent corporation and a subsidiary which is owned 95 percent or more by the parent or by a group of affiliated corporations, and provided the option permitting the inclusion of such subsidiary for income-tax purposes through the medium of a consolidated return as a branch of the business rather than as a separate entity. Section 1502 of the bill reduces the level of stock ownership to 80 percent, thus greatly enlarging the scope of the consolidated return provisions. The new test is mandatory, not merely permissive—that is, the new affiliates are required, not merely permitted, to be included if a consolidated return is filed at all.

Primarily because of the tax on intercompany dividends which became effective in 1936, many companies have integrated their business through the dissolution of their subsidiaries wherever it was practicable so to do. We believe that generally where the subsidiary has been retained its dissolution has been found impracticable, either because of legal requirements or business necessity.

Accordingly the retention of the 2-percent penalty on consolidated returns imposes a disproportionate part of the tax burden on a business which finds it necessary to operate through subsidiaries as compared with one that can be conducted by means of a single company. There is no justifiable ground for this discrimination and the 2-percent penalty for filing consolidated returns should be removed as was recommended by the President in his message of January 21, 1954.

LOSS ON INVESTMENTS IN AFFILIATES

The national emergency which has existed over the last 15 years has taught industry that its members can work with one another in the promotion of developments. Unfortunately, however, these developments are not always successful. Since they are generally carried on in corporate form, the loss which the participants incur will be treated as a capital rather than an ordinary loss, under both existing law and the bill, because no one of the corporate participants will own the required percentage of the stock of the development corporation (95 percent under existing law and 80 percent under the bill).

In order to remedy this situation, we recommend that section 165 (g) (3) of the bill, dealing with losses in affiliated corporations, be amended so as to require ownership of no more than 25 percent (instead of 80 percent) of the stock of the issuing corporation. Investments by a corporation in 25 percent of the stock of another corporation are not as a rule stock speculations. In other words, the difference between 25-percent ownership and 80-percent ownership is not necessarily the difference between speculation and investment. The bill should recognize this fact. The national emergency has proved that such investments can be of material benefit to the Nation and they should not be discouraged by the income-tax laws.

INTERCORPORATE DIVIDENDS

From 1918 to the end of 1935 dividends received by one domestic company from another were not subject to Federal income tax. However, beginning with 1936, 15 percent of intercompany dividends have been subject to tax.

In 1936 the income-tax rate was only 15 percent so that the effective tax rate on intercompany dividends when first imposed amounted to only 2.25 percent. Under the 52 percent income-tax rate now in effect, the dividend tax amounts to 7.8 percent and the burden of this unwarranted tax has become much more serious than in 1936.

There is no justification for subjecting business profits to tax at the corporate level more than once. The President's message of January 21 recognized this and recommended that the corporate deduction for dividends received be raised from its present 85 percent level to 100 percent in 3 annual steps. This recommendation of the President should be adopted.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Because of the exhaustive nature of the many analyses of subchapter C which have already been presented in the Finance Committee hearings, in the light of which we understand this portion of the bill is being completely overhauled,

any detailed discussion on our part would serve no useful purpose. Nevertheless, there are certain major points which we believe it is worthwhile to call to the committee's attention, as follows:

(1) The effective date should be sufficiently after the enactment date to give fair warning to all taxpayers. We suggest January 1, 1955.

(2) We do not agree with the transfer-tax approach to the bail-out problem. If retained, it should not apply to pre-1954 issues of nonparticipating stock.

(3) Sections 275, 312 (c) (1) and (2), and 312 (d) in combination are too broad in their approach to the so-called thin-incorporation problem. The fact that the particular debt in question may be subordinated or may be in the form of income notes or debentures does not mean it is not bona fide debt. It is difficult to see the justification for disallowance of the interest deduction. The approach should be abandoned. In any event, it should not be applicable to past issues or to parent-subsidiary situations.

(4) There is much that is admirable in part II. Nevertheless, there are certain changes which we believe desirable, viz:

(*a*) Except for the limited class of cases involving acquisition of assets through acquisition of stock, followed by prompt liquidation, we recommend restoration of the old section 112 (b) (6) approach to intercorporate liquidations because of its avoidance of the valuation problems present in the bill.

(*b*) Where stock is purchased to acquire assets the acquiring corporation should be permitted to apply the cost basis of the stock to the assets without regard to the nature of the assets acquired. The collapsible corporation problem should be handled as it is under existing law, not by penalizing the purchaser.

(*c*) The dividend approach is inappropriate in connection with intercorporate liquidations involving foreign subsidiares. If gain is recognzed, it deprives the parent corporation of capital gains treatment, which cannot be justified and, we believe, was not intended. If gain is not to be recognized, then a mere specification that the dividends received deduction under section 243 (a) shall be raised to 100 percent will not accomplish the desired purpose, for section 246 provides that there shall be no dividends received deduction for dividends received from a foreign corporation.

(5) No distinctions should be drawn in the field of corporate reorganizations between publicly held and privately held corporations or based on the relative sizes of the participants.

(6) Section 358 of the bill provides in part that the provisions of part I of subchapter C limiting the recognition of gain are not applicable to a foreign corporation unless prior to the transaction it has been established to the satisfaction of the Secretary that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Included in part I of subchapter C is section 305 which, among other things, deals with receipt by a shareholder of a stock dividend and, in effect, provides that no gain or loss is recognized on the receipt thereof. The new legislation evidently contemplates that advance clearance by the Secretary is required if no gain is to be realized on receipt of a stock dividend from a foreign corporation. In addition to raising constitutional problems, the requirement of advance clearance may impose an impossible burden on United States stockholders of foreign corporations who normally would have no advance notice of or control over stock dividends. The requirement should be eliminated.

NET OPERATING LOSS CARRYFORWARDS AND CARRYBACKS

In response to the contention that the so-called economic-loss limitations should be removed from the operation of the net operating loss carryforward and carryback provisions, section 172 of the bill makes two changes in existing law, viz: (1) It eliminates the adjustment based on wholly tax-exempt interest and (2) it permits a carryover or carryback to be used as a deduction without further adjustment for percentage depletion, dividends received, capital gains and losses, etc., in the year to which the loss is carried. It continues to apply economic-loss limitations, however, in the computation of the net-operating loss itself and in determining how much is used up in the particular taxable year.

We believe that the economic-loss limitations should be removed in their entirely. The whole purpose of the net-operating loss carryforwards and carrybacks is to equalize the tax treatment of businesses of the feast-and-famine type and those with relative stability of income. In other words, it operates on the averaging principle. To the extent the economic-loss limitations are operative this purpose is defeated. There is no reason why the feast-and-famine taxpayer

should be deprived of the benefit of provisions available to other taxpayers. The principle of equality of treatment which underlies the averaging system requires that the same statutory rules for computing taxable income should be applied to all taxpayers.

CAPITAL GAINS AND LOSSES

We submit that taxpayers should be allowed deduction for the excess of net long-term capital losses over net short-term capital gains in the year incurred, with tax benefit limited to the rate of tax applicable to the excess of net long-term capital gains over net short-term capital losses.

Such net losses, in the case of a corporation, are usually the result of transactions which are an integral and essential part of the corporation's operations. Accordingly, such transactions should not be penalized as though they were some form of undesirable speculation. The excess of net long-term capital losses over net short-term capital gains should be allowed in full and the carryover provisions of section 1212 of the bill should be limited, in the case of corporate taxpayers, to the excess of net short-term capital losses over net long-term capital gains.

ORGANIZATIONAL EXPENSES

Section 248 of the bill permits, for the first time, the amortization of certain organizational expenses.

We believe there are two serious defects in the section as presently drawn. First, it should not be limited to organization expenses, but should cover reorganization expenses as well. Second, it should also cover stock-issuance expenses whenever incurred. These would include SEC and stock exchange filing fees, State filing fees; Federal, State, and local taxes; engineering and accounting services, investment counsel fees, costs of prospectus preparation—and other items incident to the stock issue. It should be noted that the expenses of bond issues are deductible pro rata over the term of the issue. Failure to grant comparable treatment to the cost of issuing stock creates an undesirable discrimination against equity financing.

STAMP TAXES ON CORPORATE INDEBTEDNESS

The Internal Revenue Code has long imposed a stamp tax on the issuance of "bonds, debentures, or certificates of indebtedness issued by any corporation, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities." For many years this language was held by the Bureau of Internal Revenue not to include an instrument called a note, unless it had interest coupons attached or was in registered form. In *General Motors Acceptance Corporation* v. *Commissioner* (161 F. (2d) 593 (2d Cir., 1947), *cert. den.*, 332 U. S. 810), however, the term "debenture" was extended to cover many of these instruments, particularly those evidencing insurance company loans, but no objective standards for resolving particular cases were laid down. That this decision in effect changed the law as previously understood was early recognized by the Bureau in the form of a ruling which announced that it would not be applied retroactively (special ruling Sept. 1, 1948, 485 CCH par. 6228).

The present situation is one of utter confusion. Every case is sui generis. No one is certain of the answer on any given state of facts. Neither the GMAC case itself nor Bureau efforts to clarify the situation have been of much practical help. A simple comparison of *Belden Mfg. Co.* v. *Jarecki* (192 F. (2d) 211 (7th Cir., 1951)), which the taxpayer won, with the GMAC case, which the taxpayer lost, shows how unpredictable these cases are.

So far as known, there was never any real complaint over the law as previously understood, on the part either of the Government or of taxpayers. Certainly the current situation, being a source of constant controversy and frequent litigation, is extremely unsatisfactory. Sections 4311, 4331, and 4381 of the bill have not clarified this situation. It is therefore recomended that section 4381 (a) should be changed to read as follows:

"SEC. 4381. DEFINITIONS.

"(a) CERTIFICATES OF INDEBTEDNESS.—For purposes of the tax imposed by sections 4311 and 4331, the term "certificates of indebtedness" means bonds, debentures and all other instruments which are issued by a corporation and which have interest coupons attached or are in registered form."

STAMP TAXES ON INCREASE IN CAPITAL STOCK VALUE

Subchapter A of chapter 34 of the bill continues the tax on the issuance of capital stock previously imposed by section 1802 (a). It also continues an ambiguity of the earlier provision which we believe should be clarified at this time.

The tax has been interpreted by the Bureau as applying to mere increases in the stated value of capital stock without the issuance of any shares. This view has been overruled in *United States* v. *National Sugar Refining Co.* (113 F. Supp. 157 (S. D. N. Y., 1953)). We believe that the opinion in this case, viz, that the tax does not apply to increases in capital stock which are the result of mere book transfers to the capital account unaccompanied by the issuance of any shares, should be made plain in H. R. 8300.

ACCUMULATED EARNINGS TAX

Section 531 of the bill imposes a penalty tax on the accumulated taxable income of certain corporations. While the intent should always have been to penalize unreasonably accumulated income, no provision is made for the exemption of the reasonable portion.

While we are aware that the necessary definitions are difficult we do not think that this should be allowed to impose an unjust burden on income, which is not the type of unreasonable accumulation at which the section is aimed.

We believe that the reasonable accumulation should be excluded from the definition of accumulated taxable income.

STATUTE OF LIMITATIONS FOR TRANSFEREES

The Ways and Means Committee report states that when a transferee has agreed to extend the period for assessment with respect to the transferor's liability, the period for filing claim for refund is extended for the period of the agreement and 6 months thereafter, as in the case of a taxpayer who executes an agreement under section 6511 (c). The bill, however, in section 6901 (d) restricts the refunds to which this extension applies, to overpayments made by the transferee.

We recommend that a transferee's right to file a refund claim should also include taxes paid by the transferor in such cases and, even in the absence of an agreement, should include the additional period of essessment granted to the Commissioner by section 6901 (c).

INTEREST ON DEFICIENCIES AND REFUNDS

We recommend that deficiency interest be limited to the period during which the tax could be assessed without reference to any waiver by the taxpayer, plus the period following the issuance of a 90-day letter, if any, covering the deficiency. In the ordinary case this would mean that interest would run for 3 years plus the period following the issuance of the 90-day letter. The 3-year period would be correspondingly longer where the statute of limitations for making assessments without a waiver is longer, as in the case of the 5-year statute on understatement of gross income, etc. In fraud cases, where there is no statute of limitations, there would, of course, be no limitation on the running of interest.

A corresponding adjustment of refund interest is also recommended. That is to say, in cases where the claim is not filed until after the expiration of the ordinary statutory period for the filing of refund claims, there should be no interest for the time between the expiration of such period and 6 months after the claim is filed.

The recommendation is also made that in mixed refund and deficiency cases involving several years, principal be set off against principal, and interest against interest, in lieu of the present method of setting off the principal of a proposed refund against principal and interest of deficiencies. This present method reduces the amount on which refund interest is paid.

ACCELERATED TAX-PAYMENT SCHEDULE FOR CORPORATIONS

The acceleration of tax payments now in effect creates financial difficulties for corporations with limited working capital. The new provisions proposed by H. R. 8300 would aggravate these difficulties. Over the next 5 years a corporation's funds would be depleted by 50 percent of its annual income-tax liability.

It is difficult, if not impossible, for a corporation to estimate its annual income before the end of the year. To avoid penalty for an underestimate, it would be necessary to base estimated payments on the results of the prior year. In a recession period, such payments would be an added financial burden. It should be borne in mind that there is a time lag between the earning of corporate income and its reduction to cash, and the estimated tax liability cannot be paid by unrealized accounts receivable or other noncash assets.

Lest the apparent analogy of the estimated payments made by individuals should prove misleading, it should be recalled that at the time such provisions were adopted it was found necessary to forgive a substantial part of 1 year's liabilities

This provision is inconsistent with others in the bill intended to stimulate growth, encourage research, etc. The impetus to growth given by these provisions would be nullified by the loss of working capital over the next 5 years through advance taxpayments.

DATE FOR FINAL DECLARATION OF ESTIMATED TAX (INDIVIDUALS)

Under section 6051 of the bill, an employer is not required to furnish employees with withholding receipts (Form W-2) until January 31 following the close of the year. This date was chosen in order to allow employers as much time as possible to assemble the necessary data and prepare such forms.

The relatively adequate time thus provided by law is to some extent nullified, however, by section 6015 (f), which permits individuals to avoid making a final declaration of estimated tax by filing a final income tax return on or before January 15. While the general requirement that the taxpayer should attach his W-2 forms is lifted in such cases by regulation if such forms have not yet been made available by the employer, this relaxation of the general requirement is not noted on the return form or in the instructions, nor is it generally known. Moreover, even taxpayers who are aware of the fact that the availability of the W-2 forms is not a condition precedent to early filing are nevertheless reluctant to prepare their returns without such forms, in part because of uncertainty as to the exact amounts involved and in part because of the confusion to which filing a return without withholding receipts might lead. Consequently, great pressure is put upon employers to furnish such receipts prior to the time prescribed by law. This places a great burden upon such employers, who are subjected to additional expense in the form of overtime pay, disruption of the orderly functioning of their payroll departments, and neglect of other equally pressing accounting tasks.

It is doubtless also true that the lack of coordination between section 6051 and the individual return requirements precludes early filing in many cases, thereby causing duplication of effort on the part of individual taxpayers and the Government as well as delay in the collection of the revenue.

We recommend that this situation be corrected by extending at least to January 31 the date by which taxpayers must file their final declaration or, in lieu thereof, may file their final tax return.

(Whereupon, at 1:20 p. m., the committee recessed, to reconvene at the call of the chairman.)

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