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INTERNAL REVENUE CODE OF 1954

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H. R. 8300

A BILL TO REVISE THE INTERNAL REVENUE LAWS
OF THE UNITED STATES

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Calendar No. 1635

83d Congress 2d Session | SENATE | Report No. 1622

INTERNAL REVENUE CODE OF 1954

June 18, 1954.—Ordered to be printed

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

REPORT

[To accompany H. R. 8300]

The Committee on Finance, to whom was referred the bill (H. R. 8300) to revise the internal revenue laws of the United States, having considered the same, report thereon with amendments and recommend that the bill as amended do pass.

I. General Statement

Your committee has joined with the House Committee on Ways and Means in undertaking the first comprehensive revision of the internal revenue laws since before the turn of the century and the enactment of the income tax. This revision includes a rearrangement of the provisions to place them in a more logical sequence, the deletion of obsolete material, and an attempt to express the internal revenue laws in a more understandable manner.

In addition to the rearrangement, however, H. R. 8300, both as passed by the House and as amended by your committee, contains many substantive changes in the code. In general, the purpose of these changes have been to remove inequities, to end harassment of the taxpayer, and to reduce tax barriers to future expansion of production and employment.

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

This bill is a long overdue reform measure which is vitally necessary regardless of the momentary economic conditions and should not be confused with other measures which may be, or might become, appropriate in the light of a particular short-run situation. The bill has been developed through extensive and lengthy study of ways and means of removing tax inequities and tax restraints. Its passage will lead to increased employment and a higher standard of living.

Slightly over half of the revenue loss in the fiscal year 1955, which is expected to result from the provisions of this bill, represents amounts which will be available to individuals. Section II indicates that about $850 million out of a total revenue loss of approximately $1.5 billion will go to individuals. This is without taking into consideration the fact that this bill continues the present level of the corporate rate for 1 more year. This continuation of the present corporate rate is expected to produce approximately $1.2 billion in revenue for the Government in the fiscal year 1955. With this taken into account the revenue loss under this bill is about $277 million.

This bill is only 1 of 4 steps taken with respect to taxes so far in 1954. Congress has already allowed the excess-profits tax to expire as of December 31, 1953, and permitted an individual income tax reduction of approximately 10 percent to go into effect as of the same time. For the fiscal year 1955 the former represents a saving to businesses of approximately $1.6 billion, and the latter a saving to individuals of $3 billion. Moreover, Congress has already enacted an excise tax reduction bill which will reduce excise tax collections in the fiscal year 1955 by approximately $1 billion. These measures which have been enacted, or allowed to become effective, represent tax reductions of approximately $5.6 billion. Of this, approximately $3.8 billion has gone to individuals and in large measure represents additional funds available for consumer spending. This bill as amended by your committee will increase the savings to individuals by approximately $850 million and to corporations by about $630 million. As a result, individuals after the passage of this bill will have received reductions under the 4 tax measures of $4.7 billion and corporations will have received a reduction in their tax burden of $2.4 billion. This represents an over-all reduction for the fiscal year 1955 of $7.1 billion. These figures do not take into account extensions of present rates since these merely continue existing tax levels.

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

II. Revenue Effects

Estimated revenue effect in the fiscal year 1955 of H. R. 8300 as passed by the House, as compared with the changes made by the Senate Committee on Finance

[Money amounts in millions of dollars]

	Estimated loss or gain (+)		Number of taxpayers affected	
	House	Committee on Finance	House	Committee on Finance
Individuals:				
Full split income for head of family	50	....	800,000	....
Dividends received:				
Exclusion, $50 in 1954 and $100 thereafter	45	46	....	....
Tax credit, 5 percent August 1954 to July 1955 and 10 percent thereafter	195	197	....	....
Total, dividends received	240	243	7,000,000	7,100,000
Taxation of annuities on life expectancy	10	10	800,000	800,000
Deduction for certain dependents regardless of earnings	75	75	1,300,000	1,300,000
Dependent deduction for members of taxpayer's household who meet support test	10	10	100,000	100,000
Retirement income credit	125	141	1,500,000	1,800,000
Deduction of interest charge on installment contracts	10	....	1,600,000	....
Medical expense deduction:				
Increase in limitation	10	10	....	....
Reduction in exclusion from 5 to 3 percent	115	115	....	....
Limitation on drugs and medicines to the excess of 1 percent of adjusted gross	+45	+45	....	....
Total, medical expense deduction	80	80	8,500,000	8,500,000
Child-care deduction	40	130	300,000	2,100,000
Exemption for distributable trusts (increased from $100 to $300)	3	3	....	....
Premium payment test on life insurance	25	25	10,000	10,000
Increase charitable contribution limitation from 20 to 30 percent	25	25	160,000	160,000
Soil and water conservation expenditures	10	10	500,000	500,000
Depreciation	75	77	9,600,000	9,600,000
Taxing partnerships and proprietorships as corporations	....	20	....	60,000
Effect on individuals	778	849	....	....
Corporations:				
Natural resources: [2]				
Depletion	27	[1] 34	....	....
Allow capital gains treatment for iron ore royalties	....	10	....	....
Total, natural resources	27	44	4,000	5,000
Treatment of income from foreign sources: [2]				
Treatment of branch profits	95	....	....	....
14 percent differential rate	55	....	....	....
Denial of differential rate on manufactured products imported	+5	....	....	....
Removal of overall limitation on foreign tax credit	2	2	....	....
Total, treatment of income from foreign sources	147	2	4,000	1,000
Depreciation:				
Allow declining balance at 200 percent of straight line	300	300	....	....
Allow declining balance on full cost of construction completed after Dec. 31, 1953	....	32	....	....
Restrict declining balance to assets with useful life of 3 or more years	....	+9	....	....
Total, depreciation	300	323	600,000	600,000
Net operating loss: [2]				
Extend carryback to 2 years	90	90	....	....
Adjustments for dividends received and depletion	10	30	....	....
Total, net operating loss	100	120	50,000	50,000

[1] Does not include any estimate for uranium, thorium, or vanadium. Data confidential.

[2] A small part of this estimate applies to individuals, but this cannot be clearly segregated.

Estimated revenue effect in the fiscal year 1955 of H. R. 8300 as passed by the House as compared with changes made by the Senate Committee on Finance—Con.

[Money amounts in millions of dollars]

	Estimated loss or gain (+)		Number of taxpayers affected	
	House	Committee on Finance	House	Committee on Finance
Corporations:—Continued				
Denial of dividends-received credit for dividends from insurance companies	[1] +27		4,000	
Removal of 2 percent surtax on consolidated returns of regulated public utilities		35		([2])
Tax on earnings improperly accumulated		10		([2])
Allow corporations with 10 or less stockholders to file as partnerships		50		100,000
Continuation of 26 percent capital gains rate to Apr. 1, 1955		+9		60,000
Accounting provisions [3]	45	47	600,000	600,000
Total corporations exclusive of rate extension [3]	592	622		
Extension of the 52 percent rate	+1,200	+1,200	600,000	600,000
Total corporations [3]	+608	+578		
Alcohol distilled spirits (strip stamps)		6		([2])
Grand total	170	277		

[1] Not included in House report.

[2] Less than 500.

[3] A small part of this estimate applies to individuals, but this cannot be clearly segregated.

Source: Staff of the Joint Committee on Internal Revenue Taxation.

III. Tax on Individuals and Corporations

A. *Combination of Normal Tax and Surtax (sec. 1)*

(*1*) *House changes accepted by committee*

Under present law the individual income tax rate structure consists of a 3-percent normal tax and a graduated surtax.

Since the definition of income subject to the normal tax and the surtax is the same for the vast majority of taxpayers, the retention of the separate normal tax and surtax represents an unecessary complication.

Accordingly, in both the House and the committee bill the normal tax and surtax rates have been combined into a single rate schedule. This simplification is made possible by providing a credit against tax (in a subsequent provision) equal to 3 percent of the interest received on Federal Government bonds, exempt from the normal tax but subject to the surtax.

(*2*) *Changes made by committee*

None.

B. *Head of Family (sec. 2)*

(*1*) *House changes*

Under present law, half the benefits of income splitting are extended to persons who qualify as "heads of households." The term "head of household" is defined as a single individual who maintains in his home a child, grandchild, or any person whom he claims as a dependent.

The House provision substantially revised this provision. It gave a "head of family" the full benefits of income splitting rather than half of such benefits. It also provided that the dependent qualifying the taxpayer as a head of family need not live in the taxpayer's household. On the other hand, it required the taxpayer to support the dependent giving him the "head of family" status even in the case of his children. In addition, the House bill limited the classes of dependents which could qualify the taxpayer for this status. Under the House bill these dependents were limited to the taxpayer's son, daughter, father, mother, brother, or sister and, if his spouse was dead and he had not remarried, to relatives bearing a similar relationship to her.

(2) Changes made by committee

Your committee has restored present law. Thus, heads of households will continue to receive half, rather than full, benefits of income splitting and the dependents qualifying the taxpayer for such status must live in the taxpayer's household. On the other hand, any dependent for whom the taxpayer may claim a dependency exemption, may qualify the taxpayer for this treatment. Moreover, in the case of his own children, the taxpayer need not support the children nor do the children's earnings need to be limited to $600 for the taxpayer to obtain head of household status so long as the taxpayer supplies more than half the cost of maintaining the home.

Your committee's action was based on a complaint that this provision did not treat all income groups equally and benefits primarily the middle- and upper-income groups.

By restoring present law in this area, it is estimated that your committee is saving $50 million which would have been lost under the House bill.

C. Corporate Income-Tax Rate (sec. 11)

(1) House changes accepted by committee

Under present law the corporate normal tax as of April 1, 1954, automatically decreased from 30 to 25 percent. Thus, the present 52 percent maximum corporate rate as of this date reverted to 47 percent.

Both the House and your committee's bill extend the 52 percent rate (30 percent normal tax rate) for 1 year. Thus, the April 1, 1954 reduction scheduled by present law will occur on April 1, 1955.

While your committee is reluctant to continue the present abnormally high tax on corporate income, it agrees with the House that the present budgetary situation requires a 1-year extension of the 52 percent rate.

The continuation of the present corporate rate is expected to save approximately $1.2 billion in revenue for the Government in the fiscal year 1955.

(2) Changes made by committee

IV. Credits Against Tax

A. Dividends Received by Individuals (secs. 34 and 116)

(1) House changes accepted by committee

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 is due to the fact that dividends unlike wages or interest do not constitute a deduction to the corporation.

This results in a higher tax burden on distributed corporate earnings than on other forms of income. In addition, it has contributed to the impairment of investment incentives. Capital which otherwise would be invested in stocks is driven into channels which involve less risk in order to escape the penalty of double taxation. This restricts the ability of companies to raise equity capital and has forced them to rely too heavily on borrowed money. 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.

The House and your committee have reduced double taxation by adopting two related provisions: One (sec. 116) affords complete relief from the double tax on small amounts of dividend income. Under both versions of the bill an individual may exclude from his gross income up to $50 of dividend income received from a domestic corporation during a taxable year ending after July 31, 1954, and before August 1, 1955. In subsequent taxable years he may exclude up to $100 of his dividend income. These exclusions are granted for each taxpayer which means that a husband and wife filing a joint return will have two exclusions where each is a dividend recipient.

In addition, the other provision (sec. 34) under both versions of the bill provides relief by making available a dividend-received credit for part of the corporate tax paid on the dividends in excess of the amount excluded. This is a credit against tax, equal to 5 percent of dividend income above the exclusion received after July 31, 1954, and before August 1, 1955, and 10 percent of dividend income above the exclusion received after July 31, 1955.

The amount of the credit is limited to 2 percent of taxable income in 1954, 7 percent in 1955 and 10 percent in subsequent years. This limitation restricts the credit to the amount of dividend income which actually enters into the tax base. The use of 2 percent and 7 percent for 1954 and 1955 removes the necessity of prorating income in the 2 years.

The August 1 date for the credit was selected in order to minimize the likelihood that corporations will change the dates of dividend payments in the year in which the credit is introduced or increased.

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. Moreover, 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. In addition, the dividend-received credit is not available to nonresident alien individuals not subject to the regular individual income tax. (For differences in the treatment of dividends of insurance companies under the House and your committee's bill see (2) below.)

The proposed dividend exclusion and credit confers partial relief for double taxation in the most administratively feasible manner. Moreover, the method of adjustment adopted affords greater relief for the low-income investor than for those at higher income levels. The percentage reduction of tax under the combined dividend exclusion and credit is greatest in the lowest bracket and declines progressively as the income level rises. For example, in the case of a married couple filing a joint return, the 10-percent credit alone will reduce existing tax liabilities on dividend income in the $4,000 first bracket (subject to a 20-percent rate) by 50 percent; on dividend income in the $12,000–$16,000 bracket (subject to a 30-percent rate) by 33 percent; and on dividend income in the $32,000–$36,000 bracket (subject to a 50-percent rate) by 20 percent. At very high income levels, the percentage reduction in tax on dividend income will be about 11 percent.

The combination of a dividend exclusion and a credit for dividends received was adopted in preference to various other methods to relieve the existing double taxation of dividend income. A credit to corporations for dividends paid would be unsatisfactory because it would in effect make the remaining corporation income tax an undistributed profits tax, or a tax on retained earnings, the principal source of equity capital. Also, a dividend paid credit for corporations would completely relieve from tax dividends received by tax-exempt organizations.

The method of relief from double taxation selected is a modification of the dividends received credit adopted in Canada in 1949. However, the present Canadian credit is 20 percent instead of 10 percent. Moreover, limiting the credit to the amount of taxable income, when it is less than the amount of dividends, is a restriction not imposed under the Canadian system. On the other hand, the dividend exclusion provided is more liberal than the Canadian method for persons receiving small amounts of dividend income.

In effect, the 5-percent or 10-percent credit exempts dividend income from 5 percent to 10 percent of the tax rate applicable to an individual's income. In this country, prior to the middle 1930's, dividends were exempt from the normal individual income tax, which was generally the first bracket rate. This gave recognition to the fact that the income from which they were paid had already been taxed at the corporate level. It was not considered appropriate, however, to give a credit equal to the entire 20-percent first bracket rate.

Another suggestion has been to give the dividend recipient a deduction in computing taxable income for some specified percentage of dividends received instead of the credit against tax. However, this proposal was rejected because it gives higher proportionate tax relief to stockholders in the upper income brackets.

(2) *Changes made by committee*

Your committee made one substantive change in the dividend credit and exclusion provisions provided by the House bill for individuals. Under the House bill the exclusion and credit are denied with respect to dividends paid by any insurance companies. Your committee's bill follows the House provision in denying the credit and exclusion with respect to dividends paid by life insurance companies (companies taxed under secs. 801–807) and mutual insurance companies other than life, marine, or fire insurances issuing perpetual policies (companies taxed under secs. 821–823). However, your committee's bill allows the exclusion and credit with respect to dividends paid on stock of other insurance companies (companies taxed under secs. 831–832). Thus, exclusions and credits will be allowed with respect to dividends paid by such insurance companies as stock fire, casualty, title, and marine insurance companies.

The House committee report indicates that the tax concession for dividends was limited to those cases where the dividend income actually bore a substantial double tax. Your committee agrees with this reasoning and has for that reason followed the House provisions with respect to life insurance companies and mutual companies taxable under parts I and II of subchapter L. However, other insurance companies for the most part pay the full corporate tax. For that reason it was believed that the exclusion and credit should be available with respect to dividends of such companies.

It is estimated that the dividend-exclusion and dividend-received credit provided by the bill will reduce revenues by $243 million in the fiscal year 1955.

B. Retirement Income Credit (sec. 37)

(1) House changes accepted by committee

Under existing law, benefits payable under the social security program and certain other retirement programs of the Federal Government are exempt from income tax. No similar exemption is accorded to persons receiving retirement pensions under other publicly administered programs, such as teachers, as well as persons who receive industrial pensions or provide independently for their old age. In order to adjust this differential tax treatment, the House bill grants an individual who is 65 years of age or over a credit against his tax liability equivalent to the tax, at the first bracket rate, on the amount of his retirement income up to $1,200. Retirement income is defined to include pensions and annuities, interest, rents, and dividends. Since some types of retirement pensions are already excluded from gross income, an adjustment is made to avoid duplication. The amount of retirement income up to $1,200 which an individual receives is to be reduced, for purposes of computing the credit, by any social security, railroad retirement, military retirement pension, or other retirement pension which is excluded from gross income. Military disability pensions or workmen's compensation payments, however, do not serve to reduce retirement income.

Since the benefit of the credit is intended for retired individuals, the bill employs substantially the same test of retirement as that adopted for social-security purposes. An individual would be permitted to earn up to $900 a year as an employee or in self-employment without affecting the amount of the retirement credit. However, earnings in excess of $900 reduce, dollar for dollar, the amount of retirement income on which the credit is based. If an individual's earnings equal $2,100, he would receive no tax credit for any retirement income. This provision has been modified by your committee as described below.

The bill also adopts a work-qualifying test similar to one used for social-security purposes to determine whether an income recipient above the age of 65, who is not deriving earned income, is a person who was actually engaged in gainful employment prior to age 65. Thus, to qualify for the credit an individual must have derived earnings of at least $600 a year in each of any 10 years prior to the taxable year. A widow whose spouse would have qualified under this requirement is herself qualified. Where a husband and wife meet this requirement, each can qualify for the retirement credit.

Income which qualifies for the retirement credit may also be the basis for other credits. Income from certain Government bonds, for example, would entitle a taxpayer to a partially tax-exempt interest credit as well as to a retirement-income credit. Hence, provision is made to avoid tax refunds by virtue of such double credit. The retirement credit may not exceed the tax computed after deducting any credit allowed with respect to foreign taxes, dividends received by individuals, and partially tax-exempt interest.

(2) Changes made by committee

In many cases, public retirement systems provide for the retirement of covered employees before the age of 65. The House bill, by limiting the retirement income credit to individuals 65 years of age or over, would exclude such persons although the purpose of the provision is to afford relief to individuals depending for their livelihood on their pensions or similar retirement payments. Your committee's bill extends the retirement income credit provided by the House bill to pensions, annuities, or similar payments received from public retirement systems by individuals less than 65 years of age.

In addition, your committee has eliminated the reduction of the amount of retirement income to which the credit may be applied for earnings in excess of $900 a year in the case of an individual 75 years of age or over.

It is estimated that this provision will decrease revenues by $141 million in the fiscal year 1955.

V. Deductions in Arriving at Adjusted Gross Income

A. Transportation Expenses (sec. 62 (2) (C))

(1) House changes accepted by committee

At present, business transportation expenses can be deducted by an employee in arriving at adjusted gross income only if they are reimbursed by the employer or if they are incurred while he was away from home overnight. Business transportation expenses not falling in these categories presently cannot be deducted unless the employee is willing to forego the use of the standard deduction and itemize all of his deductions.

Because these expenses, when incurred, usually are substantial, it appears desirable to treat employees in this respect like self-employed persons. For this reason both the House and your committee's bill permit employees to deduct business transportation expenses in arriving at adjusted gross income even though the expenses are not incurred in travel away from home or not reimbursed by the employer. Thus, employees will be able to deduct business transportation expenses and still use the standard deduction. The business transportation expenses which are deductible under this provision include only expenses for actual travel, such as payments to others for transportation or, if the individual's own car is used, the cost of gasoline, oil, auto repairs, and depreciation.

The new transportation deduction is not available for commuting expenses between home and the place of employment since these are not business expenses.

(2) Changes made by committee

None.

B. Business Expenses of Outside Salesmen (sec. 62 (2) (D))

(1) House changes accepted by committee

As in the case of the transportation expenses described above, business expenses of an "outside salesman" who is an employee presently may be deducted in arriving at adjusted gross income only if they are reimbursed or incurred while he is away from home overnight.

If these salesmen were independent contractors they would be permitted to take business expense deductions in computing adjusted gross income and still use the standard deduction. Moreover, the business expenses incurred by outside salesmen usually are substantial relative to their incomes.

Both the House and your committee's versions of this bill treat outside salesmen in effect like self-employed persons with respect to these expenses, permitting their deduction of expenses in arriving at adjusted gross income even though the salesmen use the standard deduction. These deductions include expenditures for meals, split commissions paid on subcontracts, etc. An "outside salesman" is defined as an employee engaged principally in the solicitation of business for his employer at places other than the employer's place of business.

(2) Changes made by committee

None.

VI. Special Inclusions in Gross Income

A. Alimony and Separate Maintenance Payments (sec. 71)

(1) House changes accepted by committee

Present law taxes to a recipient and allows the payor a deduction for periodic alimony or separate maintenance payments if the payments are a legal obligation imposed by a court decree or by a written agreement incident to a decree.

Attention has been called to the fact that the present treatment discriminates against husbands and wives who have separated although not under a court decree.

For this reason both the House bill and your committee's bill extend the tax treatment described above to periodic payments made by a husband to his wife under a written separation agreement even though they are not separated under a court decree if they are living apart and have not filed a joint return for the taxable year.

(2) Changes made by committee

Your committee made two changes in the House provision relating to alimony and separation payments. It provides that the treatment described above is to be effective only with respect to written separation agreements executed after the date of enactment of this bill. It also provides that this treatment is to be applicable where a wife is separated from her husband if she receives periodic payments from him under any type of decree (entered after the date of enactment of this bill) requiring the husband to make payments for her support and maintenance.

Your committee made the first of these 2 amendments in order to prevent the upsetting of arrangements which already have been worked out with the understanding that the wife would not include the payments in her income. In such cases it appears probable that tax effects were taken into account in determining the size of the payments. The second amendment was made by your committee to cover cases where amounts made under a court decree for support have not been called separate maintenance payments. So long as the husband and wife are separated and not filing a joint return it would appear that the tax effect in such cases should be the same as in the case of a decree of separate maintenance.

B. Annuities (sec. 72)

(1) House changes accepted by committee

The so-called 3 percent rule under present law taxes an annuitant on the annuity payments he receives to the extent of 3 percent of the amount he paid for the annuity. Any payments he receives above this amount are considered to be the return of his capital and are excluded from tax until the cumulative amount excluded equals the amount he paid for the annuity. Thereafter, the annuity payments received are taxable in full.

This present rule is objectionable because it is erratic. Where the amount paid for the annuity represents a large proportion of its value at the time payments begin, the present rule does not return to the annuitant on a tax-free basis the amount he paid for the annuity during his lifetime. On the other hand, where the amount the annuitant paid for the annuity represents a small proportion of its value at the time payments begin, the exclusion is used up rapidly. In such cases the annuitant finds that after being retired for a few years and becoming accustomed to living on a certain amount of income after tax, he suddenly has to make a sizable downward adjustment in his living standard because, when his exclusion is used up, the annuity income becomes fully taxable.

The House bill and your committee have adopted a provision which spreads the tax-free portion of the annuity income evenly over the annuitant's lifetime. In the usual case the exclusion will equal the amount the annuitant paid for the annuity, divided by his life expectancy at the time the payments begin. This exclusion is to remain the same even though he outlives this life expectancy. Under this rule the company providing the annuity will be able to supply the annuitant with a statement indicating that for the rest of his life a stated amount of his annuity income will be excluded annually from his income subject to tax.

So employees will not have to make computations where small amounts of exclusions are involved, an individual receiving a pension financed in part by contributions from his employer will not be taxed under the life expectancy method if the amounts payable under the annuity in the first 3 years equal, or exceed, his cost for the annuity. Such individuals are to exclude all annuity payments until they have recovered their capital tax free; thereafter, all annuity payments will be taxable in full except, of course, for the retirement income credit which may exempt as much as $1,200 of this income each year.

Any refund paid to a beneficiary at the death of an annuitant is to be exempt from tax. However, to avoid granting a double exclusion, the annuitant's cost (to be spread tax-free over his expected life) is to be reduced by the refund anticipated computed in accordance with his life expectancy.

In the case of joint and survivor annuities, the cost of the annuity, in determining the annual exclusion, is to be spread over the combined life expectancy of the annuitants.

The life expectancies of those already receiving annuity payments will be determined as of January 1, 1954, and the cost, or consideration, to be recovered tax-free will be reduced by any amounts already recovered tax-free under the 3-percent rule.

The rule described above applies to payments for a fixed number of years as well as to payments for life. Amounts received under a paid-up endowment contract also will be taxed in this manner where the policyholder elects, within 60 days after he has the right to receive a lump sum, to receive the payments in installments instead.

(2) Changes made by committee

Your committee made certain technical corrections to the annuity section passed by the House, including corrections in the House rule for determining the size of the estate-tax deductions which may be taken by the secondary annuitant. These rules were moved to section 691 relating to income in respect of a decedent.

It is estimated that the new annuity rules will decrease revenues by $10 million in the fiscal year 1955.

C. Payments Other Than Annuities Received Under Annuity or Endowment Contracts (sec. 72 (e) and (h))

(1) House changes accepted by committee

Individuals frequently receive under annuity contracts amounts which are not strictly speaking annuity payments, such as dividends and amounts received from the surrender, redemption or maturity of the annuity contract. Under present law, such amounts are taxed to the extent that they exceed the portion of the consideration paid for the contract which has not previously been recovered free of tax.

The House bill and your committee's bill make two changes in the present treatment. First, proceeds other than annuity payments which do not constitute a complete discharge of the carrier's obligation under the annuity contract (for example, dividends as contrasted with amounts received from the surrender of the contract) are to be taxed in full without any exclusions, if received on or after the date the annuity payments begin. The reason for the change is that if part of such proceeds were excluded, it would be necessary to recompute the annual annuity exclusions allowed under the life expectancy method used in the taxation of annuities. Where the proceeds from the annuity contract are received either before the date annuity payments begin or in full discharge of the contractual obligation these proceeds will be taxed, as under existing law, only to the extent that they exceed the consideration.

A second change made gives relief where such proceeds are received in a lump sum in one year. In such cases, the tax on the lump-sum proceeds cannot exceed the tax which would be payable if such proceeds had been received in three equal installments: one in the year of receipt, and the other two in the two preceding years.

(2) Changes made by committee

Your committee added language to provide that face amount certificates would be treated in the same way, with respect to taxation of the investor as endowment insurance.

D. Prizes and Awards (sec. 74)

(1) House changes accepted by committee

Both the House and your committee's versions of the bill include in income subject to tax all prizes and awards except those made in recognition of past achievements of a religious, charitable, scientific, educational, artistic, literary, or civic nature, where the recipient was selected without any action on his part and is not required to render substantial future services. This exception is intended to exempt such awards as the Nobel and Pulitzer prizes.

The provision eliminates the confusion resulting from certain court decisions. The Pot O'Gold case and the Ross Essay Contest case are overruled insofar as these cases held the receipts not to be income under the code. In these cases the courts held that prizes on give-away programs and prizes for winning essays are not includible in income subject to tax.

Scholarships and fellowships are not covered by the rules described above. These are provided for in a separate section (sec. 117 discussed in VII-H).

(2) Changes made by committee

None.

E. Discharge of Indebtedness (secs. 76 of the House bill, 108, 1017)

(1) House changes accepted by committee

Under existing law, a corporation is permitted to exclude from income amounts attributable to the discharge of indebtedness if the indebtedness was evidenced by a security and the corporation also elects a corresponding reduction in the basis of its property. Because of the required reduction of basis of property, the income from discharge may be taxed at a later date through reduced deductions for depreciation or a lower basis for capital gain. Railroads may exclude income attributable to cancellation where the cancellation is made pursuant to bankruptcy or receivership proceedings without having to make a corresponding reduction in basis of property. This special provision for railroads is inapplicable after December 31, 1954. The National Bankruptcy Act also contains a number of provisions permitting exclusion of income attributable to discharges under bankruptcy. A reduction in basis of the debtor's property is often required.

The House bill expands present law to permit the exclusion of all or part of income attributable to discharge of indebtedness if the indebtedness was incurred by a corporation, or an individual in connection with property used in his trade or business. Following present law, the debtor may exclude such income only if he applies the amount so excluded to reduce the basis of any property held during any portion of the taxable year in which the discharge occurred.

The provision relating to railroads is extended to December 31, 1955, as a few roads would otherwise be deprived of the benefits received by roads reorganized in past years. No change is made in the provisions of the National Bankruptcy Act.

(2) Changes made by committee

Your committee has deleted section 76 of the House bill which set forth a general rule that discharges of indebtedness by the debtor for less than full value shall result in income to the debtor unless the creditor and debtor have, because of the nature of their dealings, consummated a transaction of a capital nature. In the latter cases, the discharge for less than full value might be deemed a gift, a contribution to capital, or adjustment of purchase price or property.

Your committee made this deletion because testimony before its hearings revealed that the House draft was the cause of considerable doubt as to its meaning and effects. Deletion of this section will leave the situation as it now exists, with the determination as to whether cancellation results in income to the debtor, and to what extent, to be settled according to rules developed by the courts.

VII. Exclusion From Gross Income

A. Proceeds of Life Insurance Contracts Payable by Reason of Death (sec. 101 (a))

(1) House changes

Under present law life-insurance proceeds payable by reason of death are exempt from tax. However, where an insurance contract is transferred for a valuable consideration, only the actual value of the consideration and subsequent premiums paid by the transferee are tax exempt and the balance is taxable as income. The House bill grants full exemption to life-insurance proceeds payable at death where the contract is transferred for a valuable consideration.

(2) Change made by committee

Your committee believes that the procedure in the House bill may result in abuse in encouraging speculation on the death of the insured and therefore has reinstated present law with respect to contracts transferred for a valuable consideration. However, it is made clear that complete exemption is to be granted to life-insurance proceeds paid under contracts which have been transferred for certain legitimate business reasons rather than for speculation purposes. In conforming with the changes made by your committee in the treatment of employees' trusts, there has been deleted the provision of the House bill which would have taxed the proceeds (in excess of the $5,000 employee death benefit exclusion) of life insurance purchased for a participant in an exempt employees' trust.

B. Employees Death Benefits (sec. 101 (b))

(1) House changes accepted by the committee

Present law provides a special exclusion of up to $5,000 for payments by an employer to beneficiaries of a deceased employee. Your committee adopts three changes in these provisions made by the House.

The amount excludable because of the death of any employee is limited to a total of $5,000 per employee to prevent individuals from increasing the exemption by arranging to have two or more employers each pay $5,000 of death benefits.

The exclusion is also made available regardless of whether the employer has a contractual obligation to pay the death benefits.

The $5,000 exclusion is extended to lump-sum distributions paid by reason of death under a qualified employees' profit-sharing and stock bonus plan even though the employee had a nonforfeitable right to the amounts while living.

(2) Changes made by the committee

Your committee bill also extends the $5,000 exclusion to distributions from qualified pension plans on the same basis as distributions from profit-sharing and stock-bonus plans. The purpose of this change is to provide uniform treatment for lump-sum distributions granted because of death by the various types of employee plans.

C. Life Insurance Proceeds Paid in Installments (sec. 101 (d))

(1) House changes

Present law exempts proceeds of life insurance paid by reason of death even though such proceeds are paid in installments and include interest earned after the death of the insured. The House bill limits the interest exclusion in connection with life insurance installment proceeds to $500 a year for a widow of a decedent and $250 a year for lineal decedents and ancestors of the decedent. The House bill extends the interest exclusion, subject to these limits, to so-called excess interest or policy dividends.

(2) Changes made by committee

Your committee's bill accepts the principle in the House bill that it is desirable to place a limit on the exemption now granted to interest earned on life insurance paid in installments. However, your committee substitutes for the exclusions provided by the House a $1,000 a year exclusion for the widow. No exclusion is allowed for other beneficiaries. The widow is granted the exclusion to encourage her to take the life insurance proceeds in installments so as not to waste the principal. There appears to be little reason to grant an exclusion to children since even if the mother is dead their interest in the principal is protected by guardianship laws while they are young. Moreover, when children reach majority there appears to be no reason to encourage them to leave the proceeds in any particular form.

D. Accident and Health Plans Financed by Employers (secs. 104 and 105)

(1) House changes

Under present law amounts received as accident or health benefits under employer pension plans are exempt if paid under a contract of insurance and are taxable if paid under noninsured plans. The House bill would grant the same treatment to sickness and accident benefits financed by employers whether paid under insured or noninsured plans. Such benefits would be (1) entirely excluded from tax if received as compensation for personal injury or sickness and (2) excluded up to $100 a week if received as compensation for loss of wages under a plan providing a waiting period.

These exclusions would be granted under the House bill only to benefits paid out by qualified plans which would be required to satisfy nondiscrimination rules generally similar to those provided in the House bill for pension plans. Also, the House bill requires that when nonqualified payments are made for loss of wages, that the $100 exclusion for payments under qualified plans be offset by payments received under the nonqualified plans.

(2) Changes made by the committee

Your committee approves in principle of the general objective of the House provision in equalizing the tax treatment of insured and noninsured sickness and accident benefits. Like the House bill, your committee's bill provides for an exclusion of up to $100 a week for payments for personal injury or sickness made under a plan financed by the employer where the payments are in lieu of wages. However, this exclusion applies only to payments which are attributable to a period beginning 7 days after the beginning of the injury or sickness.

Benefits which reimburse the employee for expenses incurred for his own medical care and for the medical care of his spouse or his dependents will also be exempt. In addition, your committee's bill makes it clear that certain payments for injury if made without regard to the employee's absence from work are to be exempt. There are payments for the permanent loss (or loss of use) of a member, or function, of the body or for permanent disfigurement. These payments may be made with respect to the taxpayer, his spouse, or his dependents.

The qualification rules provided in the House bill have been eliminated. This was necessary because your committee, for reasons developed in the discussion on pensions, stock-bonus and profit-sharing plans, abandoned the automatic qualification rules provided by the House bill. Without these rules it would be necessary in most cases to obtain specific rulings from the Internal Revenue Service in the case of each employer sickness and accident plan, if the requirement had been kept that they must be qualified to receive the treatment described above.

Your committee's bill also specifically indicates that amounts paid by an employee association as well as amounts paid by an employer are eligible for exemption if they fall in the exempt categories indicated above.

E. Rental Value of Parsonage (sec. 107)

(1) House changes accepted by committee

Under present law, the rental value of a home furnished a minister of the gospel as a part of his salary is not included in his gross income. This is unfair to those ministers who are not furnished a parsonage, but who receive larger salaries (which are taxable) to compensate them for expenses they incur in supplying their own home.

Both the House and your committee has removed the discrimination in existing law by providing that the present exclusion is to apply to rental allowances paid to ministers to the extent used by them to rent or provide a home.

(2) Changes made by committee

None.

F. Income Taxes Paid by Lessee Corporation (sec. 110)

(1) House changes accepted by committee

Under many long-term leases, the lessee contracts to pay a fixed income to the lessor corporation (or its stockholders) without reduction for income taxes assessed on the rental payment.

Under present law the lessor is deemed to derive additional taxable income from the income tax paid on its behalf by the lessee. The lessee, in turn, is required to pay the tax on such income for the lessor, and so on. This tax on a tax is pyramided to the point where the income tax liability paid by the lessee is greatly in excess of the initial tax on the rental. Although the lessee is entitled to deduct such tax payments in computing its own income tax liability, under some conditions the taxable income of the lessee is not sufficiently large to absorb this deduction, with the result that no tax benefit is realized.

Under the House and your committee's bill, the income tax liability payable by the lessee on such rental income is to be excluded from the lessor's gross income and denied as a deduction to the lessee. This applies only to leases entered into before January 1, 1954, where both lessee and lessor are corporations.

This provision adopts for income tax purposes a rule which has been in effect with respect to excess profits tax liabilities.

(2) Changes made by committee

None.

G. Combat Pay of Members of the Armed Forces (secs. 112 and 692)

(1) House changes accepted by committee

Present law provides an exclusion from gross income for members of the Armed Forces serving in combat zones or hospitalized as the result of wounds, disease, or injury incurred while serving in such a zone. In the case of enlisted personnel, this exclusion is granted for all pay received for service in a combat zone or while hospitalized as a result of such service; for commissioned officers the exclusion is limited to the first $200 of pay received in a month. Under present law this exclusion is available only for service in a combat zone between June 24, 1950, and January 1, 1955.

Your committee agrees with the House that this exclusion should be available for any period in which persons are generally subject to induction into the armed services under the Universal Military Training and Service Act. For that reason the House and your committee's bill provide that this exclusion is to be available with respect to service in a combat zone after June 24, 1950, during an "induction period."

Present law also has a special tax forgiveness provision applicable to an individual who dies after January 24, 1950, and before January 1, 1955, while in the Armed Forces if his death resulted from service in a combat zone. Any income tax he owes the Government at the time of his death is forgiven. As in the case of the exclusion, the House and your committee's bill extend this provision to apply to service in a combat zone after June 24, 1950, during an "induction period."

(2) Changes made by committee. None.

H. Scholarships and Fellowship Grants (sec. 117)

(1) House changes accepted by committee

Present law contains no provision regarding treatment of scholarships and fellowship grants. The basic ruling of the Internal Revenue Service which states that the amount of a grant or fellowship is includible in gross income unless it can be established to be a gift has not provided a clear-cut method of determining whether a grant is taxable.

The House bill adds a new section which provides rules for determining the extent to which amounts received as scholarships and as fellowship grants are to be included in gross income. The section first states the general rule that amounts received as scholarships or as fellowship grants are excludible from gross income and then prescribes specific rules for limiting the amounts which may be excluded. The general rule specifies that the exclusion extends to the value of contributed services and accommodations (such as room, board, and laundry) which are received as part of the scholarship or fellowship grant. The exclusion also applies to amounts received to cover incidental expenses for travel, research, clerical help, or equipment which are incident to the scholarship or fellowship to the extent that they are expended by the recipient for these purposes.

Your committee's bill adopts the general rule provided by the House bill, but makes certain amendments to the limitations placed on the amount which may be excluded.

(2) *Changes made by the committee*

The House bill provides that the exclusion shall not apply to that portion of any amount received which represents payment for teaching or research services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. Your committee extends the provision to include "other services" in addition to teaching and research services. Your committee has also specifically provided that if teaching, research, or other services are required of all candidates, for a particular degree (whether or not recipients of scholarship or fellowship grants) such services are not to be regarded as part-time employment.

The House bill provided a specific standard for determining the taxability of grants received by individuals who are not candidates for a degree, typically the recipients of post doctoral fellowships. Such grants may be in effect a continuing salary payment while the recipient is on leave from his regular job. The House bill specified that such grants are excludible only if the annual amount of the grant plus any compensation received from the recipient's previous employer is less than 75 percent of the recipient's salary in the year preceding the grant. Cases were brought to your committee's attention in which the formula of the House bill would tax grants which were clearly not a continuing salary payment. In many of these cases taxability would result from the absence of a substantial earned income in the previous year. Your committee therefore has substituted for the 75 percent rule an exclusion of $300 per month of grants paid to individuals who are not candidates for degrees. The exclusion will not be allowed beyond a total of 36 months.

In the case of individuals who are not candidates for degrees, your committee's bill allows the exclusion only if the grantor is a tax-exempt organization described in section 501 (c) (3), the United States or its instrumentality or agency, or a State, Territory, or a possession of the United States, or their political subdivisions, or the District of Columbia.

I. Contributions to the Capital of a Corporation (secs. 118 and 362 (c))

(1) *House changes accepted by committee*

The House and your committee's bill provide that in the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

In a section dealing with the basis of property contributed to a corporation both the House and your committee's bill provide that a corporation takes a zero basis for contributions to capital by nonstockholders.

(2) Changes made by committee

Your committee made only technical changes in the basis section applicable to contributions to capital. This provision was made applicable to acquisitions after June 18, 1954, instead of the effective date of the bill. Also the committee deleted the provision in the House bill indicating that the basis provision was not applicable in the case of gifts.

J. Meals and Lodging (sec. 119)

(1) House changes accepted by committee

Under present law meals and lodging have been held to be taxable to the employee unless they were furnished for the convenience of the employer. Even in such cases, however, they would not be excluded from the gross income of the employee if there is any indication that they are intended to be compensatory. For example, under present law it has been held that the value of meals and lodging are includible in the employee's income, even where they are furnished for the convenience of the employer, if there is an indication that the meals and lodging were taken into account in establishing the salary paid.

The House and your committee has adopted provisions designed to end the confusion as to the tax status of meals and lodging furnished an employee by his employer. Under both bills meals and lodging are to be excluded from the employee's income if they are furnished at the place of employment and the employee is required to meet certain other conditions specified below.

(2) Changes made by committee

Your committee believes that the House provision is ambiguous in providing that meals or lodging furnished on the employer's premises, which the employee is required to accept as a condition of his employment, are excludable from income whether or not furnished as compensation. Your committee has provided that the basic test of exclusion is to be whether the meals or lodging are furnished primarily for the convenience of the employer (and thus excludable) or whether they were primarily for the convenience of the employee (and therefore taxable). However, in deciding whether they were furnished for the convenience of the employer, the fact that a State statute or an employment contract fixing the terms of the employment indicate the meals or lodging are intended as compensation is not to be determinative. This means that employees of State institutions who are required to live and eat on the premises will not be taxed on the value of the meals and lodging even though the State statute indicates the meals and lodging are part of the employee's compensation.

K. Subsistence Payments to State Police Officers (sec. 120)

(1) House changes accepted by committee

The House and your committee's bill provide an exclusion from gross income not to exceed $5 a day, for subsistence allowances paid to officers of a police department of a State, Territory, the District of Columbia, or a possession. There is no comparable exclusion under existing law. It is believed that this exclusion is desirable because State police officers are required to make frequent trips away from their posts of duty. Under present law these expenses cannot be deducted if the police officer is to use the standard deduction.

(2) Changes made by committee

None.

VIII. Personal Exemptions

A. Earnings Test for Dependent (sec. 151)

(1) House changes accepted by committee

Under existing law a $600 exemption may be taken for a dependent only if he has gross income of less than $600. Thus, if a child helps to pay his way through school by securing part-time employment, the parent is denied a dependency exemption if the child happens to earn more than $600. Not only does this represent a hardship to parents who provide most of the support for their children, although the latter earns slightly over $600, but it also represents an inducement for the child to stop work just before his earnings reach the $600 level.

The House and your committee's bill provide that the $600 earnings limit for dependents is not to be applicable if the dependent is the taxpayer's child and is under the age of 19 or is a student. The term "student" is defined as an individual who is a full-time student at an educational institution during 5 months of the year. An "educational institution" is one which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. This excludes correspondence schools, employee training courses, and similar institutions and programs.

(2) Changes made by committee

For the purposes of determining whether or not an individual is a student and therefore may earn over $600 and still qualify as a dependent, your committee has made a change in the House bill. As an alternative to qualifying as a full-time student at an educational institution an individual is considered as a student under your committee's bill if he is pursuing a full-time course of institutional on-farm training under the supervision of an educational institution or State or local governmental unit. Your committee believes that those obtaining practical training in the running of a farm are equally deserving of the tax benefit provided here with those attending regular educational institutions.

B. Definition of Dependent (sec. 152)

(1) House changes accepted by committee

Under existing law a dependent is defined as an individual over half of whose support is received from the taxpayer and one who bears 1 of 8 specified relationships to the taxpayer.

The House and your committee's bill modify the support test in two respects. It is provided that in the case of children of the taxpayer who are students, any scholarships they receive for study at an educational institution are to be ignored in applying the support test. This is believed to be desirable since a taxpayer who is sending his child through college, even with the help of a scholarship, is likely to be incurring more expenses for the child than is true in the case of taxpayers with dependents not in college.

Another problem is presented in connection with the support test where two or more persons supply the support of another individual but no one can claim the dependency exemption because of the failure of any one to supply more than one-half of the support. Sometimes the contributors are able to vary their contributions from year to year in order to qualify one of them. In most cases, however, such arrangements are difficult and frequently all of the contributing group lose the dependency exemption. Under both versions of the bill a group of contributors may annually designate one of their number to claim the dependency exemption where no one in the group contributed more than half of the dependent's support if all of the tests with respect to the dependency exemption (except the support test) are met by each member of the group; the person designated to receive the dependency exemption has contributed more than 10 percent of the dependent's support; and all other members of the group who have contributed more than 10 percent of the support have agreed in a written statement that they will not claim the exemption for that year.

The House and your committee's bill also modify the "relationship" test of existing law. Many complaints have been received that the relationships specified in existing law are not sufficiently flexible to allow for the various types of situations under which taxpayers frequently support an individual in their home. This point is most frequently raised in the case of foster children or children in the home awaiting adoption. As a result both versions of the bill provide that a taxpayer may claim as a dependent an individual over half of whose support he supplies, irrespective of the relationship of such individual to the taxpayer, if the individual has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. A dependency exemption is also provided for cousins of the taxpayer, whom he supports, who are receiving institutional care (required by reason of a physical or mental disability) but prior to being placed in the institution were members of the same household as the taxpayer.

At present individuals may not be claimed as dependents if they are not citizens or residents of the United States unless they are residents of a contiguous foreign country. Both versions of the bill expand this exception for contiguous countries to permit taxpayers to claim as dependents individuals who are not United States citizens but are residents of the Canal Zone, Panama, and in certain cases the Philippines. For a resident of the Philippines to qualify he must be a child born to or adopted by the taxpayer in the Philippines before July 5, 1946, and the taxpayer must have been a member of the United States Armed Forces at the time the child was born or adopted.

(2) *Changes made by committee*

No substantial changes.

C. Revenue Effect

It is estimated that the change in the earnings test and the definition of dependents will decrease revenues by $85 million in the fiscal year 1955.

IX. Itemized Deductions for Individuals and Corporations

A. Trade or Business Expenses (sec. 162)

(1) House changes accepted by committee

At the present time corporations are allowed a deduction for charitable contributions up to a limit of 5 percent of their income otherwise subject to tax. In addition, they are allowed to take as business-expense deductions contributions to charitable and other organizations where the institution is to render a service commensurate to the contribution. However, where no service is rendered, a business-expense deduction may not be taken for amounts not allowable as charitable contributions only because they are in excess of the 5 percent limitation. However, in the case of individuals, there has been some question as to whether or not a business-expense deduction can be claimed for gifts (for which no service is to be rendered) which are in excess of the percentage limitation applicable to individuals.

The House and your committee's bill make it clear that the rule presently applicable to corporations is also to be applicable in the case of individuals.

(2) Changes made by committee

Your committee made no changes in the House provision.

B. Interest (sec. 163)

(1) House changes

The House provision which the committee deleted is described below.

(2) Changes made by committee

Since interest payments are deductible under present law, administrative practice has allowed a deduction for carrying charges on installment purchases if the interest element is stated separately. The House added a provision permitting an interest deduction for carrying charges on installment purchases even where the interest is not stated separately. The deduction in this case is limited to 6 percent of the average unpaid balance due under the installment contract during the taxable year.

Your committee deleted this new House provision because it did not believe that it should encourage the practice of hiding the interest charge imposed under some other name. Moreover, the House provision is believed undesirable because it creates a presumption that the proper interest charge is 6 percent. It should also be pointed out that the interest deduction itself is only available where taxpayers itemize their deductions rather than using the standard deduction. Because only a small proportion of the taxpayers in the lower income-tax brackets itemize their deductions, it appears unlikely that the deletion of this deduction will effect a significant number of taxpayers whose installments are substantial. It is believed that the administrative complications of such a deduction outweigh its value.

It is estimated that your committee's deletion of this provision will save $10 million in revenue over the House bill in the fiscal year 1955.

C. Taxes (sec. 164)

(1) House changes accepted by committee

Under present law, a taxpayer who buys real estate may be denied a deduction for the local property taxes which he assumes and pays if under local law the seller of the property had become liable for the tax prior to the date of sale. This occurs because the Supreme Court has held that the deduction for taxes depends upon the time when the tax becomes a lien upon the property. If, for example, the tax lien attached to the property before the date of sale, only the seller would be allowed to deduct the tax for income-tax purposes, regardless of the manner in which the sales contract allocated the tax between buyer and seller. The purchaser would be allowed no deduction but would include the portion of the tax he paid in the basis of the property.

To correct this situation, the House and your committee's bill provide that the purchaser and seller of real property are to each claim a deduction for that part of the real property tax which is proportionate to the number of months in the property tax year during which he held the property. This provision applies whether or not the parties to the sale actually apportion the tax. A special rule extends the benefit of this provision to cash basis taxpayers.

(2) Changes made by committee

Because your committee amended section 461 (c) to make the accrual of real property taxes over the related period elective, section 164 has been amended to provide a special rule, which will make the apportionment of real property tax between buyer and seller inapplicable in cases where either of the parties is an accrual basis taxpayer who has not elected under section 461 (c). In addition, your committee has amended section 164 to permit the deduction of taxes assessed by special districts for debt retirement and capital purposes. To be deductible, the assessments must be levied annually at a uniform rate on the same assessed value of real property in the district as is used for purposes of the general local property tax; the district must include at least one complete county; and the tax must be levied with respect to at least 1,000 taxpayers.

D. Theft Losses (sec. 165 (e))

(1) House changes accepted by committee

The regulations under present law indicate that generally ordinary losses can be taken only in the year in which they are sustained. In the case of embezzlement and other theft losses, however, the taxpayer may not find out about the loss until the statute of limitations has run for the year in which the loss was incurred.

The House and your committee have adopted a provision which provides that theft losses can be deducted in the year in which the taxpayer discovers the loss, and only in that year.

(2) Changes made by committee

None.

E. Losses on Securities in Affiliated Corporations (sec. 165 (g))

(1) House changes accepted by committee

Present law provides that a parent corporation may take an ordinary loss on worthless stock or securities, held in a subsidiary 95 percent of the stock of which it owns, if 90 percent or more of the gross income of the subsidiary for all years is derived from sources other than rents, royalties, and other investment-type income.

Applying this 90 percent test on the basis of "gross income," which is after the deduction of the cost of goods sold, means that a decline in the gross profit margin (or a loss) may reduce non-investment-type income to less than the required 90 percent.

For this reason the House and your committee have amended this provision to permit ordinary loss treatment if the subsidiary company derives 90 percent or more of its "gross receipts" from non-investment-type income. However, in the case of the sale of stock only gains are to be included for this purpose. Since "gross receipts" is before deduction of cost of goods sold, the change makes this provision somewhat less restrictive.

(2) Changes made by committee

The House bill also reduces from 95 to 80 the percent of the stock which a parent corporation must hold in a subsidiary in order to take an ordinary loss on worthless stock or securities of the subsidiary. The report of the House committee indicates that this percentage was reduced in order to conform it with the change made in the general affiliation requirement which must be met if two or more corporations are to file a consolidated return. As will subsequently be explained, however, your committee has restored the 95-percent affiliation requirement for the filing of consolidated returns. Because of that your committee has also restored the 95 percent requirement for ordinary loss treatment on worthless stock or securities of a subsidiary.

F. Bad Debts (sec. 166)

(1) House changes accepted by committee

Under existing law, business bad debts may be deducted in full. Nonbusiness bad debts of an individual, however, are treated as short-term capital losses which can be deducted from capital gains but in the case of ordinary income are deductible only to the extent of $1,000 (although there also is a 5-year carryover).

If a debt at the time it becomes worthless is not directly related to the taxpayer's trade or business, under present law it is treated as a nonbusiness bad debt. This rule is applied even though the debt was related to the taxpayer's trade or business at the time it was created. For example, a taxpayer is not permitted to treat as a business bad debt, which is fully deductible, an account receivable which proves uncollectible after the taxpayer has gone out of business.

The bill eliminates this harsh treatment by permitting the taxpayer to deduct as a business bad debt an obligation which becomes worthless, whether or not it is directly related to the trade or business at that time, if it was a bona fide business asset at the time it was created or acquired.

(2) Changes made by committee

Your committee has removed the provision in the House bill which denied a bad debt deduction in the case of mortgage foreclosures covered by section 1035. The treatment of foreclosures is discussed under that section.

Your committee also provided that business bad debt treatment will be available where a noncorporate taxpayer, who was the endorser (or guarantor or indemnitor) of the obligation of another, is required to pay the other's debt (and cannot collect it from the debtor). However, this treatment is to be available only where the debt represents money used in the other person's trade or business. Your committee believes that this treatment should be available in such cases since in most cases debts of this type usually are incurred because of business relationships.

G. Depreciation (sec. 167)

(1) House changes accepted by committee

Your committee accepted, with some modifications, the basic provisions of the House bill liberalizing depreciation allowances, primarily through the extension of the use of the declining-balance method at double the corresponding straight-line rate, applicable to new property acquired or constructed after December 31, 1953.

The House bill provides for a liberalization of depreciation with respect to the method of allocating the depreciable cost over the years of service.

Depreciation allowances computed under any one of the following methods are to be considered reasonable for new property acquired or constructed after December 31, 1953:

(1) The straight-line method allowable under present law.

(2) The declining-balance method, using a rate not in excess of twice the straight-line rate. Under this method a uniform percentage is applied to the unrecovered basis of the property. Since the basis of a particular property is constantly reduced by prior depreciation, the percentage is applied to a constantly declining balance. The depreciation allowances under this method, therefore, are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining-balance method depreciates 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life.

(3) Any other method consistently applied so long as the accumulated depreciation allowances for a property at the end of each year do not exceed the allowances which would have resulted from the use of the declining-balance method described above. Alternative methods which would be considered reasonable would include those based on units of production or a combination of straight-line rates.

The liberalized depreciation methods provided in the bills are to apply to all types of tangible depreciable assets, including farm equipment, machinery, and buildings, rental housing, and industrial and commercial buildings as well as machinery and equipment. They are limited, however, to property new in use and therefore never before subject to depreciation allowances.

The bill limits the application of the liberalized depreciation methods to new assets acquired after the effective date of the bill primarily as a means of minimizing transitional revenue losses and obtaining maximum incentive effect. The application of the new methods to used property might artificially encourage transfers and exchanges of partially depreciated assets motivated only by tax considerations. The stimulus to investment through liberalized depreciation is most important with respect to the creation of new assets. Moreover, the reality of faster depreciation in the early years is generally greater in the case of new than used property.

The liberalized declining-balance method included in the bill concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles.

More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.

Small business and farmers particularly have a vital stake in a more liberal and constructive depreciation policy. They are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by this bill will permit them to secure short-term loans which would otherwise not be available.

The House bill also contains a provision which your committee has accepted for removing sources of irritation and fruitless controversy in administering depreciation policy. It provides that where the taxpayer and the Internal Revenue Service have agreed in writing to a rate of depreciation to be applied to a particular property or to a group account, that rate will continue to be appropriate for tax purposes until such time as evidence is produced which was not taken into consideration when the agreement was made. The burden of proving the evidence rests with the party initiating the change in rate. When the necessity for a change has been established it will be made only prospectively.

(*2*) *Changes made by committee*

Your committee has adopted a number of changes and modifications in the House bill provisions in the depreciation area designed to meet problems and criticisms described below.

One change made by your committee removes possible uncertainty as to the status of other methods not specifically set forth in the bill. Some believed the House bill precluded depreciation allowances which have been acceptable under present law or might be proved reasonable under present law. There was apprehension that otherwise reasonable deductions might appear to be denied by the provision limiting the accumulated allowances to the total provided under the double declining-balance system. To meet this criticism and assure taxpayers that the bill will not operate to cut back their allowances below present law, your committee has made changes indicating that nothing in the new treatment is to be construed as limiting or reducing an allowance otherwise allowable under the general provision for reasonable depreciation allowances.

An important change made by your committee liberalizes the treatment of unrecovered cost at end of service life. A characteristic feature of the proposed declining-balance method under the House bill is that it leaves an unrecovered portion of some 10 to 13 percent of cost at the end of service life. In computing the deduction under the declining-balance method, the depreciation rate is multiplied by the entire unrecovered cost of the asset. While no specific set-aside is made at the end of useful life this procedure automatically leaves an unrecovered residual at the end of useful life which in some cases may represent an unrealistically high estimate of salvage value. Where the asset is a single item the amount unrecovered can be deducted as a loss when the asset is sold or abandoned. With respect to a group of items, such as machines, if a taxpayer maintains records of his depreciable assets by year of acquisition he may deduct the entire remaining unrecovered cost of a given year's acquisitions at the time of retirement of the last surviving unit. If the taxpayer does not avail himself of this procedure, he would recover the 10 to 13 percent residual gradually over a long period of years subsequent to the end of the service life.

The unrealistically high salvage value at end of service life is also reflected in a relatively low level of accumulated allowances during the last third of service life. This limiting feature of the declining-balance method lessens its attractiveness. Moreover, since the accumulated allowances under the declining-balance method limit the amount allowable under other methods, this imposes a straitjacket on the use of other methods such as a combination of different straight-line rates at different stages of service life. Such other methods may not provide as much depreciation in the early years as the declining-balance method but will insure the full recovery of cost above the realistic salvage value at the end of service life.

It seems unfair to delay the writeoff of a significant portion of cost in the manner prescribed by the House bill. This drag on cost recovery due to the automatic residual under the diminishing-balance system would partially cancel its advantages, make it unattractive to some taxpayers, and weaken its effective stimulus to investment. Since the accumulated allowances under the declining-balance method serve as a standard for other eligible methods, the unrealistically high salvage value may thus restrict the use of otherwise acceptable methods.

To deal with this problem and permit greater flexibility of depreciation, your committee has adopted two specific amendments. One liberalizes the provision of the House bill which limits accumulated allowances under other reasonable and consistent methods to the amount of allowances which would have resulted under the declining-balance method. This is done by applying the limitation only during the first two-thirds of service life. This should permit wider use of other methods which permit the full amortization during the late years of a property's life of the entire cost above realistic salvage value.

The other amendment allows taxpayers availing themselves of the declining-balance method an option to switch to straight-line depreciation at any time in the life of a property. The straight-line rate would be based on the realistic estimate of remaining life of the property at the time of the switch. Moreover, the rate would thereafter be applied to the depreciated balance of the account at the time of the switch, less a realistic estimate of salvage value.

The House bill does not clearly permit the use of the sum-of-the-years' digits method of depreciation. This method results in approximately the same pattern of depreciation as the double-rate declining-balance method, with some differences which disqualify it under the House bill. This method is difficult to reduce to a brief formula but consists of the application of varying rates of depreciation, which are lower each year, to a constant balance in the property account reduced by estimated salvage. The rate for any year consists of a fraction, the numerator of which is the number of the year taken in reverse order and the denominator of which is the sum of the numbers representing the remaining years of life. To illustrate, in the case of a property with a 10-year life the rate of depreciation the first year would be $\frac{10}{55}$, 10 being the number of the year in reverse order and 55 being the sum of 1+2+3+4+5+6+7+8+9+10. The rate in the second year would decline to $\frac{9}{55}$ of the cost and in the 10th or final year to $\frac{1}{55}$.

Taxpayers have expressed considerable interest in having the sum-of-the-years' digits method available as an alternative accounting procedure. This would permit them to obtain essentially the same results as the declining-balance method without being bound by the automatic 10 to 13 percent salvage value characteristic of the declining-balance system.

To permit the unquestioned use of the sum-of-the-years' digits method, your committee has allowed it as a specific exception to the general rule limiting the accumulated allowances to those which would result under the declining-balance method.

Your committee has eliminated the "10-percent leeway" rule provided by the House bill, designed to assure a specific zone of administrative tolerance in the determination of service life. Under this provision, the Internal Revenue Service would not be permitted to disturb a depreciation rate unless the corrected rate differed by more than 10 percent from the useful life uses by the taxpayer. It appears that this provision would be considered inadequate and unsatisfactory by some taxpayers, and might be a substantial source of misunderstanding and distortion. The practical effect of eliminating this provision in assuring flexibility in administrative policy should not be great since policies already announced by the Internal Revenue Service under recent rulings should afford taxpayers freedom from annoying minor changes which would disturb the original estimate of service life.

Your committee has also adopted a number of miscellaneous minor and technical amendments listed below.

(*a*) *Use of different methods of depreciation by the same taxpayer.*—It is not entirely clear that under the House bill different methods of depreciation may be applied to different properties or different classes of property in the hands of the same taxpayer. Your committee has made changes to clarify the bill in this regard to permit the consistent use of different depreciation methods appropriate to different classes of assets.

(*b*) *Treatment of construction in process on January 1, 1954.*—The House bill provides that in the case of property under construction by the taxpayer on January 1, 1954, the new depreciation methods are to apply only to that portion of costs incurred subsequent to 1953. This discriminates against the taxpayer who conducted the construction himself as compared with a taxpayer who purchased a new building after December 31, 1953, which was still in process of construction on that date. Moreover, this provision gives rise to a difficult administrative problem in determining the portion of cost incurred after December 31, 1953. Your committee has eliminated the limitation as to the use of the liberalized methods on only the portion of construction costs incurred after December 31, 1953. This amendment would permit the entire cost of construction to be depreciated under the new methods if completed and first put into use after December 31, 1953.

(c) *Restriction of declining-balance rate on short-lived assets.*—The use of the 200-percent declining-balance rate in the case of short-lived properties would result in extremely fast writeoffs. For example, in the case of an asset with a 2-year service life, the doubling of the 50-percent straight-line rate would be equivalent to expensing the cost in the year of acquisition. These properties would retain substantial value and could be resold subject to capital gain rates.

To prevent unrealistic deductions and resulting tax avoidance, your committee has provided that the liberalized methods be made available only with respect to assets with useful lives of 3 or more years.

(d) *Technical amendment relating to depreciation improvements of mines.*—Due to faulty cross-referencing under the House bill, the liberalized depreciation systems are not extended to depreciable mine improvements. Your committee has adopted a technical amendment to correct this situation.

It is estimated that the declining balance depreciation of this bill as amended by your committee will result in a revenue loss of $400 million in the fiscal year 1955.

H. Charitable and Similar Contributions (sec. 170)

(1) House changes accepted by committee

The House bill raises the charitable contribution limit for individuals from 20 percent to 30 percent of adjusted gross income, but this extra 10 percent is to be allowable only with respect to contributions to educational institutions, hospitals, and churches and conventions of churches. The House bill also indicates that this additional exemption is to be available in the case of religious orders. As indicated below, this particular phrase is removed in your committee's bill. The term "educational institution" is defined as an organization which normally maintains a regular faculty and curriculum and normally has a regular organized body of students in attendance at the place where its educational activities are carried on.

This extra 10-percent deduction for charitable contributions is to be available with respect to any contributions to the specified types of organizations, even though contributions to other organizations account for the full amount allowable under the regular 20-percent limitation. This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds.

The House bill makes two other relatively minor changes in the charitable contribution deduction.

At present a taxpayer (either corporate or individual) who has made the maximum allowable charitable contribution, if he subsequently carries back a net operating loss to that year, finds his allowable charitable contributions have been reduced by this downward adjustment in his income. The House bill adopted a provision which will ignore the net operating loss carryback in applying the percentage limitations.

At present the 20-percent limitation on charitable contributions does not apply where the combination of the taxpayer's charitable contributions and income tax in the current year and in each of the past 10 years equals 90 percent or more of his taxable income. The House considered this unduly strict and provided, therefore, that this 90-percent test need to be met in only 9 out of the last 10 years. Your committee has further liberalized this interpretation.

(2) Changes made by committee

Your committee's bill extends the deduction for charitable contributions beyond those allowed under present law to contributions made to nonprofit cemetery and burial companies.

For purposes of determining the applicability of the 20 percent limitation on the deduction for charitable contributions by taxpayers whose contributions combined with their income tax exceeds 90 percent of their taxable income, your committee further liberalizes the House action by providing that this test need be met in only 8 out of the last 10 years.

Your committee understands that "church" to some denominations includes religious orders as well as other organizations which, as integral parts of the church are engaged in carrying out the functions of the church whether as separate corporations or otherwise. It is believed that the term "church" should be all inclusive. To retain the phrase "or a religious order" in this section of the bill will tend to limit the term and may lead to confusion in the interpretation of other provisions of the bill relating to a church, a convention or association of churches. Accordingly, your committee believes that the section of the bill will be clarified by this amendment.

It is estimated that the charitable contribution provision contained in this bill will decrease revenues in the fiscal year 1955 by $25 million.

I. Amortization of Premiums on Callable Bonds (sec. 171)

(1) House changes accepted by committee

Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or on earlier call date. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.

This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods. The bonds may then be resold after 6 months subject to long-term capital gain treatment. The writeoff of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. This process may be repeated indefinitely.

To curb this type of abuse, the House and your committee's bill provide 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 the securities. This provision will apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.

The January 22, 1954, date corresponds to the date of announcement of this action by the House committee. This effective date limitation, together with the exemption of bonds issued prior to the 3 preceding years, will prevent unfair retroactive application of the provision to previous investors or long outstanding issues. The proposal is also confined to bonds having a call date within 3 years from the original date of issue, in order to avoid disturbing market effects on issues bearing an original long-call date as they approach or come within the 3-year period prior to possible call.

(2) *Changes made by committee*

Your committee made two changes in the House provision relating to the amortization of premiums on callable bonds. It made the new House provision inapplicable in the case of tax-exempt bonds which restores present law treatment for such bonds. It also provided that where one of the bonds, to which the new House provision applies, actually is called prior to its maturity date that the taxpayer may in that year take as a deduction against ordinary income the remaining unamortized premium.

The first of these two changes by your committee stops an inadvertent loophole created by the House provision. By denying a writeoff of the premium from the date of purchase to the date of call in the case of bonds with a short call date, the House bill also reduces the downward adjustment to the basis of the bonds. In the case of taxable bonds this smaller initial basis adjustment is offset by a smaller initial deduction against income for premium amortization. However, since the premium may not be amortized against taxable income in the case of exempt bonds there is no offset in this case to the smaller initial basis adjustment. Should the exempt bonds be called at an early date the holder of the bond would realize a fictitious loss for tax purposes.

The second amendment made by your committee in effect allows ordinary, rather than capital, loss treatment in case of bonds with a call date of 3 years or less which are called prior to maturity. Where the call feature actually is used, there seems to be no justification for denying such bonds ordinary loss treatment in the year of call since in the case of most bonds it is possible to take a deduction against ordinary income over the life of the bond equal to the amount of any premium paid.

J. Net operating Loss Deduction (sec. 172)

(1) *House changes accepted by committee*

Under present law a net operating loss may be offset against net income of other years by means of a 1-year carryback and a 5-year carryforward. The House has extended the period for the carryback to 2 years. This, in combination with the 5-year carryforward, provides a total span of 8 years for absorbing a loss.

The House bill also modifies the method of computing the amount of the net operating loss. Under present law, certain adjustments are made in arriving at the amount determined to be the net operating loss. Thus, the loss is reduced for any tax-exempt interest received by the taxpayer, the excess of percentage or discovery depletion over cost depletion, the excess of nontrade or nonbusiness deductions of taxpayers other than corporations over gross income from such sources, the excess of capital losses of taxpayers other than corporations over capital gains, and the deduction with respect to long-term capital gains for taxpayers other than corporations. The corporate dividend-received credit is also of no avail to the corporation utilizing the loss carryover, since the credit is limited to 85 percent of net income, and is thus wiped out in a loss year. Under the House provisions, the adjustment for tax-exempt interest would no longer be required and thus would serve to reduce the net operating loss.

Under present law, essentially the same adjustments that are made in computing a net operating loss for a year, with the exception of the one relating to nontrade or nonbusiness expenses, are likewise made in the year to which the loss is carried before such loss may be applied against taxable income. Thus, if a 1953 loss were carried back to 1952 to be applied against 1952 income, any excess of percentage depletion over cost depletion with respect to 1952 in effect would first be used to reduce the 1953 loss carryback before it could be applied as a deduction against 1952 income. In addition, present law provides, in the case of a corporation, for a similar adjustment in the year to which the loss is carried for the dividends received credit in that year. The loss carryback in effect thus is likewise reduced by the portion of the intercorporate dividends received tax free before such loss is applied against taxable income. Under the House bill, however, no adjustments are made in the year to which the loss is carried prior to computing the amount of the net operating loss deduction. The net operating loss deduction thus will be simply the sum of all the net operating loss carryovers and all the net operating loss carrybacks to the taxable year. Certain adjustments (not including any adjustment for tax-exempt interest) will have to be made, however, in determining the income for any year which must be subtracted from a net operating loss to determine the portion of such loss which will still be available to carry to a subsequent year.

Presently the net operating losses which may be deducted by a taxpayer other than a corporation are limited to expenses or losses incurred in operating a business. But the loss on a sale of all or part of a business or its principal assets by an individual has been held to be not includible in his net operating loss on the grounds that such a sale was not attributable to the "operation" of a business. The House bill permits taxpayers other than corporations who sell a business or certain business assets to include as part of the net operating loss for the year any loss sustained on the sale of business assets. Your committee has accepted this provision.

(*2*) *Changes made by committee*

Your committee bill further modifies the method for computing the net operating loss by permitting inclusion in the loss to be carried over (*a*) the excess of percentage depletion over cost depletion and (*b*) 85 percent of dividends received from domestic corporations. This is done, first, by eliminating the requirement in the House bill and present law of an adjustment for excess depletion in the loss year, or any subsequent year from which a loss is carried. Second, for purposes of the net operating loss, the taxpayer is permitted the deduction for dividends received computed without the limitation of the latter relative to total net income. Thus the taxpayer who utilizes the net operating loss deduction will have the full benefit not only of tax exempt interest, as under the House bill, but also of all percentage depletion and of dividend received deductions. These changes will lessen the differences in tax treatment of firms with fluctuating and those with stable incomes.

It is estimated that the net operating loss provision as amended by your committee will decrease revenues in the fiscal year 1955 by $120 million.

K. Research and Experimental Expenditures (sec. 174)

(1) House changes accepted by committee

No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projects, and recovery through amortization is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.

To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the House and your committee's bill provide that these expenditures, incurred subsequent to December 31, 1953, may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided, may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized.

The tax treatment for these expenditures, once adopted, must be adhered to consistently unless approval for a change (with respect to all or a part of such expenditures) has been obtained from the Secretary or his delegate.

These options do not apply to expenditures for land or for depreciable property used in experimentation work. Also excluded are exploration expenditures incurred for minerals, oil, or gas which are presently provided for under other provisions.

(2) Changes made by committee

None.

L. Soil and Water Conservation Expenditures (sec. 175)

(1) House changes accepted by committee

Under present law expenditures made by farmers to improve their land are generally required to be capitalized rather than deducted as current expenses. The capitalized expenditures increase the farmers' tax basis for the land and are recoverable for tax purposes upon sale of the land. However, the Tax Court has held that substantial expenditures for the terracing of farms may be regarded as maintenance costs and, hence, be deducted as current expense.

The House bill permits farmers to elect to expense, rather than capitalize, expenditures for soil and water conservation, and for the prevention of land erosion, in respect of land used in farming. These expenditures include: those for the treatment or moving of earth, such as leveling, grading, and terracing; contour furrowing; the construction of diversion channels and drainage ditches; control and protection of watercourses, outlets and ponds; eradication of brush; and planting of windbreaks. These expenditures do not include the purchase or construction of facilities, appliances, and structures made of concrete, metal, and so forth, and thus subject to allowance for depreciation.

The deductions for soil and water expenditures for any 1 year are limited, however, to 25 percent of the gross income derived from farming. In any year in which actual expenditures of this type are more than the maximum deduction permitted, the excess of these expenditures may be carried over to following years.

The deduction for soil and water conservation expenditures is also limited to land which, prior to or at the same time as the expenditures for soil and water conservation are made, was or is used in farming by the taxpayer or his tenant.

Taxpayers must decide whether they are going to expense soil and water conservation expenditures in the first year after 1953 in which they have such expenditures, and must continue this policy with respect to subsequent similar expenditures unless they receive permission from the Secretary or his delegate to make a change.

(2) Changes made by committee

Amendments were adopted making it clear that the provision applies to earthen dams not subject to depreciation and to the construction, as well as the control and protection, of water courses, outlets, and ponds.

Your committee also made the provision applicable for expenditures by farmers to satisfy special assessments of soil or water conservation districts to defray expenditures made by such districts which would be deductible under this section if made directly by the taxpayer.

The House bill also provided that any expenditures in excess of the 25 percent limitation should be added to basis until such time as they become deductible in a future year to which carried. Your committee omitted this provision as being unduly burdensome for taxpayers.

It is estimated that the soil and water conservation expenditure deduction permitted by this bill will reduce revenues in the fiscal year 1955 by $10 million.

X. Special Itemized Deductions for Individuals or Corporations

A. Expenses for Production of Income (sec. 212)

(1) House changes accepted by committee

Existing law allows an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. Under regulations costs incurred in connection with contests over certain tax liabilities, such as income and estate taxes, have been allowed, but these costs have been disallowed where the contest involved gift-tax liability.

A new provision added by the House and approved by your committee allows a deduction for expenses connected with determination, collection, or refund of any tax liability.

(2) Changes made by committee

None.

B. Medical, Dental, and Similar Expenses (sec. 213)

(1) House changes accepted by committee

Present law allows the deduction of medical, dental, etc., expenses which are in excess of 5 percent of adjusted gross income, and any outlays for drugs and medicine may be included in "medical expenses." The maximum medical expense deduction allowable under present law is $1,250 for each exemption but with an overall limit of $2,500 per return or $5,000 in the case of a joint return.

Several problems have been raised in connection with the medical-expense deduction. There is general agreement that limiting the deduction only to expenses in excess of 5 percent of adjusted gross income does not allow the deduction of all "extraordinary" medical expenses. Also, in many cases the maximum limitation has created a hardship by preventing the deduction of large medical expenses actually incurred. In addition, it has been the practice of many taxpayers to deduct amounts spent for pharmaceuticals, which in many cases are not properly classified as medical expense items.

The House and your committee's bill make three major changes in this provision to meet these problems: They allow medical expenses in excess of 3 percent of adjusted gross income to be deducted, instead of only those in excess of 5 percent; outlays for drugs and medicines may be included in "medical expenses" only to the extent they exceed 1 percent of adjusted gross income; and the maximum limitations are raised from $1,250 to $2,500 per exemption, and the overall limit per return is raised from $2,500 to $5,000, or in the case of a joint return from $5,000 to $10,000. For a head of household the overall limitation is raised from $2,500 to $10,000.

Other changes in the House and your committee's bill allow the expenses of a last illness to be deducted on the final return of a decedent even if paid after death. A new definition of "medical expenses" is provided which allows the deduction of only transportation expenses for travel prescribed for health, and not the ordinary living expenses incurred during such a trip.

The reduction of the lower limitation from 5 to 3 percent and the doubling of the maximum deductions would involve a revenue loss of $125 million in the fiscal year 1955, but with the limitation on drugs and medicine this loss is reduced to $80 million.

(2) Changes made by committee

None.

C. Child-Care Expenses (sec. 214)

(1) House changes accepted by committee

The House bill provides a new deduction for child-care expenses paid by a working widow, widower, or divorced person, or a working mother whose husband is incapacitated. The deduction is limited to actual expenses up to $600, paid for the purpose of permitting the taxpayer to follow a gainful employment. Expenses paid to a person who is a dependent of the taxpayer may not be deducted. An individual deducting these expenses may not use the standard deduction.

(2) Changes made by committee

Your committee accepts the principle of the new deduction provided in the House bill but substantially liberalizes it with the following changes:

(*a*) The deduction is allowed to a working woman or a widower for expenses paid for the care of any dependent who is mentally or physically incapable of caring for himself.

(*b*) The deduction is allowed with respect to expenses for the care of a child under 12 years of age, instead of under 10 years.

(*c*) The deduction for child-care expenses may be claimed by a working wife provided she files a joint return with her husband. However, the amount of the deduction allowed is decreased by the amount by which the combined adjusted gross income of the husband and wife exceeds $4,500. Thus, no deduction is allowed where the combined adjusted gross income is $5,100 or more.

The House bill provided this deduction because it was recognized that a widow or widower with small children must incur child-care expenses in order to earn a livelihood and that these expenses, therefore, are comparable to an employée's business expenses. Your committee's action in extending the deduction recognizes that similar financial problems may be incurred by taxpayers who, if they are to be gainfully employed, must provide care for physically or mentally incapacitated dependents other than their children. Moreover, it is recognized that in many low-income families, the earnings of the mother are essential for the maintenance of minimum living standards, even where the father is also employed, and that in such situations the requirement for providing child care may be just as pressing as in the case of a widowed or divorced mother.

It is estimated that the expenses for child and other dependent care as amended by your committee will reduce revenues in the fiscal year 1955 by $130 million.

D. Taxes and Interest Paid to Cooperative Housing Corporations (sec. 216)

(*1*) *House changes accepted by committee*

Tenant-stockholders in a cooperative apartment corporation are presently allowed the same deduction for property taxes and interest available to a homeowner. Both the House and your committee's bill extend this treatment to stockholder-tenants in a cooperative development of homes.

(*2*) *Changes made by committee*

None.

E. Rules Applying to Deductions for Dividends Received by Corporations (sec. 246)

(*1*) *House changes accepted by committee*

Present law provides that in the case of dividends paid by the China Trade Act Corporations and corporations which may exclude part of their income from their tax base because they derive most of their income from United States possessions, the 85 percent intercorporate dividends received credit is not to be available to the corporation receiving the dividend. The dividends received credits for certain preferred stock of public utilities and for certain foreign corporations subject to tax in this country also are denied in the case of dividends received from corporations of these types.

The House and your committee's bill extend the denial of these credits, or deductions as they appear in H. R. 8300, in the case of dividends received from the so-called exempt organizations and from the so-called exempt farm cooperatives. As in the case of the corporations whose dividends under present law are not eligible for the dividends received credit, these corporations are free of tax with respect to these dividends. Thus, allowance of a deduction to the recipient for dividends of this type would result in their escaping entirely the corporate tax.

(2) Changes made by committee

The House bill also denies the three dividend received deductions in the case of all insurance companies. Your committee has restored present law in this respect, however, by striking out the provision denying the dividend received deductions in the case of insurance companies.

Your committee believes it is undesirable to deny these deductions in the case of dividends received from insurance companies because some types of insurance companies, such as stock fire and casualty companies, pay the full corporate tax. Moreover, in the case of the other types of companies, intercorporate arrangements have developed where corporations receiving dividends from insurance companies would be unable to meet existing commitments if denied the intercorporate dividend received credit.

F. Corporate Organization Expenditures (sec. 248)

(1) House changes accepted by committee

Under present law the expenses incurred on behalf of a corporation prior to the date of its charter and incident to its creation are not deductible. They may be amortized for tax purposes only when their useful life may be determined definitely by reference to a limited term of existence specified in the corporate charter. In the vast majority of cases where the corporate life is perpetual, organizational expenses are recovered for tax purposes only in the year of liquidation.

The House and your committee's bill provides that a corporation may elect to amortize organizational expenses over a period of not less than 60 months, beginning with the month in which the corporation is first active in business. This treatment conforms tax accounting more closely with general business accounting for these costs.

This provision is not applicable to the professional fees and other expenses incurred in connection with stock issues or transfers of corporate assets in reorganization. As is now the generally accepted practice, these expenses are to be charged directly to the capital paid in to the corporation as a result of the transaction.

(2) Changes made by committee

None.

XI. Items Not Deductible

A. Capital Expenditures (sec. 263)

For exception for intangible drilling costs and development costs in the case of oil and gas wells, see discussion under "Natural Resources," XX-G.

B. Certain Amounts Paid in Connection with Insurance Contracts (sec. 264)

(1) *House changes accepted by committee*

Your committee has accepted changes under the House bill designed to curb tax avoidance through the deduction of interest on indebtedness incurred to purchase deferred annuity contracts.

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 within 4 years from the date the contract is 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.

The 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. The 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.

(2) *Changes made by committee*

Your committee made a technical change in the effective date of this provision relating to life-insurance contracts involving the deposit of borrowed funds, making it applicable only to amounts deposited after March 1, 1954, as in the case of annuity contracts.

C. Disallowance of Losses, Expenses, and Interest Between Related Taxpayers (sec. 267)

(1) *House changes accepted by committee*

In transactions between related taxpayers, present law denies losses on sales or exchanges of property and deductions for unpaid expenses or interest.

The House and your committee's bill tightens present law by expanding the concept of related taxpayers to include (1) a fiduciary dealing with a beneficiary of any other trust created by the same grantor; (2) a fiduciary dealing with a corporation controlled by the grantor or the trust; and (3) an exempt organization controlled by a person or his family. Dealings between these parties are no less subject to abuse than those covered by present law.

Where losses on the disposition of property are disallowed, present law makes no provision for an adjustment of gain when such property is subsequently sold to outsiders.

The two versions of H. R. 8300 remedy this defect by recognizing gain to the original transferee only to the extent that it exceeds the amount of loss not previously allowable to the transferor. In this way, the combined tax results on sale of property to an unrelated taxpayer generally will be the same as if the initial sale to a related taxpayer did not take place. This new rule does not affect the basis of the property for determining gain; consequently, depreciation and other items which depend on that basis are unaffected.

(2) Changes made by committee

None.

D. Acquisitions Made To Evade or Avoid Income Tax (sec. 269)

(1) House changes accepted by committee

Existing law authorizes the Commissioner of Internal Revenue to disallow a deduction, credit, or allowance not otherwise available, in cases where control of a corporation is acquired principally for the purpose of tax evasion or avoidance. The effectiveness of this provision has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition.

Both the House and your committee's bill provide that the Government is not to have the full burden of proving that there was no purpose of evasion or avoidance in cases where the consideration paid in acquiring control of another corporation, or corporation property, is substantially disproportionate to the sum of the adjusted basis of the property and the tax benefits not otherwise available. This provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carryovers, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner. It is believed that the addition of this new provision will strengthen enforcement of existing law in an area that has presented a serious tax-avoidance problem.

(2) Changes made by committee

The House bill provided that if the amount paid to acquire control of another corporation was substantially disproportionate to the basis of the property and the tax benefits acquired that this would be determinative of the principal purpose of evasion or avoidance of Federal income tax, unless the taxpayer shows to the contrary by a clear preponderance of the evidence.

Your committee, while agreeing with the objective of the House provision, believes that the language used by the House would almost automatically disallow the tax benefits otherwise available in such cases. It believes that the taxpayer should have the opportunity of proving that tax avoidance was not the principal purpose. For that reason your committee has provided that where this substantial disproportionality exists that this shall be prima facie evidence of the principal purpose to avoid tax.

E. Hobby Losses (sec. 270)

(1) House changes accepted by committee

Under present law, if losses from a trade or business exceed $50,000 a year for 5 consecutive years, only $50,000 of the annual loss may be offset against income from other sources and the portion of annual loss above $50,000 is disallowed. This is to prevent the deduction as business losses of excessive expenditures on hobbies, such as racing stables and recreational farms. However, the present provision may in some instances penalize bona fide business enterprises, such as farms suffering from drought, mining businesses with large development costs, and businesses incurring casualty and abandonment losses.

To avoid such results, the House and your committee's bill remove from the application of this provision losses and expenses incurred by farmers because of drought, casualty and abandonment losses, and expenditures which may, at the taxpayer's option, either be capitalized or be deducted when incurred. Deductions for these items are to be omitted in computing the amount of taxpayer's loss for purposes of determining whether he has a loss in excess of $50,000. Moreover, these deductions are to be allowed even if the taxpayer's losses exceed $50,000 a year for 5 consecutive years. This provides the same treatment for these losses and expenses as is presently provided for interest and taxes.

(2) Changes made by committee

In addition to the changes made by the House bill, your committee has provided that the net operating-loss deduction is not to be taken into account in determining whether a taxpayer's losses from a trade or business exceed $50,000 for 5 consecutive years. Otherwise, an unusually large loss in 1 year might have the effect of creating losses in 5 consecutive years and bringing the taxpayer within the application of this provision.

The treatment provided for the net operating loss differs from that provided for the other specially treated deductions in that if a taxpayer is subject to this provision a deduction for the net operating loss will not be allowed.

Your committee also made it clear that the changes made by the House and your committee in this provision are applicable only with respect to years in a period of 5 consecutive years, 1 or more of which begins after December 31, 1953.

F. Cutting of Timber and Disposal of Coal, Timber, or Iron Ore (sec. 272)

See discussion under "Natural Resources," XIX–F.

G. Rental Payments to Governmental Units for Use of Manufacturing Facilities (sec. 274 of House bill)

(1) House changes

The House provision which was deleted by your committee, is discussed below.

(2) *Changes made by committee*

Present law exempts from Federal income tax interest on securities issued by States and their political subdivisions.

The House was concerned about the use of these tax-free bonds by local governmental units to finance the construction of industrial buildings for lease to private industry, because in this way the benefits of Federal tax exemption are diverted to private business in an attempt to attract local industry. The House, in an attempt to meet this problem, added a new provision to the code which disallows deductions to private businesses for rental payments made to State or local governmental units for the use of property acquired or improved by the governmental unit by the authorization of industrial development bonds after February 8, 1954.

Your committee while not unconcerned with this problem believes that further consideration needs to be given to it before any attempt is made to provide legislation. It is not clear, for example, whether the denial of the rental deduction to the lessee is the best approach to the problem. Nor is it clear that the abuse referred to arises only where revenue bonds are used to finance the property. Moreover, a number of problems arise under the House provision where a property is used for what is generally considered a public purpose, such as an airport, but as an incidental use some of the property is rented to private manufacturers.

H. Nonparticipating Stock (sec. 275 of House bill)

(1) *House changes*

This section which was not accepted by your committee is described below.

This section denied a deduction for amounts paid on nonparticipating stock. Under the definition of nonparticipating stock, this section would have disallowed as a deduction interest on income obligations. The House bill in section 312 developed a new classification of stock and securities.

(2) *Changes made by committee*

Your committee sees no reason for departing from the long established practice of treating payments on certain income obligations as interest. Moreover, such a change would present many difficulties to existing corporate enterprises where the deduction of such amounts has been taken into consideration in the various types of capital employed in the business. For this, and other reasons explained in connection with the corporate reorganization provisions, your committee has restored present law and will continue the treatment of amounts paid on income obligations as interest payments, deductible to the payor, to the extent so treated under present law.

XII. Corporate Distributions and Adjustments

Your committee has substantially recast the provisions of the House bill dealing with the tax treatment of corporate distributions and adjustments. Your committee fully shares the objectives sought to be accomplished in the House bill. It shares the belief that this part of the statute must be rewritten in order to provide a degree of certainty which is lacking in existing law. However, such certainty is not to be achieved at the expense of the legislative flexibility necessary to provide a statutory pattern which will tax, in an equitable manner, the myriad business transactions with which this area of the law is concerned. The House bill, in the opinion of your committee, contains several important provisions which, by spelling out detailed rules in an attempt to achieve almost mathematical certainty, would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws.

The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible. It has, however, not hesitated to depart from the present statute where such departure was necessary in order to remove unwarranted restrictions on necessary or desirable business transactions or to preclude the use of avoidance devices which have proved successful under the existing code. Thus, your committee would liberalize present law with respect to the nonrecognition of gain or loss in cases which involve mere rearrangements of the corporate structure while at the same time providing less liberal rules in other areas in order to insure that transactions which are in substance, although not in form, dividend distributions by corporations to their shareholders are subject to tax at ordinary income rather than at capital gain rates. The principal changes from the House bill made by your committee are as follows:

(1) The House bill departs from existing law by providing more restrictive rules as to the types of tax-free reorganizations which may be entered into by closely held as opposed to publicly held corporations. The theoretical justification for this distinction is that such transactions have, as a practical matter, been used for tax avoidance motives far more frequently by closely held than by publicly held corporations. Your committee has rejected this distinction. Not only is it difficult, if not impossible, to formulate satisfactory definitions as to the types of corporations which will be deemed "publicly held" or "closely held" for tax purposes, but there is considerable doubt as to whether it would be sound policy for the tax laws to impose greater restrictions on a class of corporations which is ordinarily small than on their larger competitors.

(2) The House bill departs from existing law by introducing the new terms, "participating stock" (corresponding in general to common stock) and "nonparticipating stock" (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term "security." Important tax consequences can flow from these definitions under the House bill. Thus, interest cannot be deducted if the instrument on which it is payable does not meet the test of a "security" as is the case with many income debentures currently outstanding. Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms "stock," "common stock", "securities," etc., and, as is the case under existing law, has not attempted to define them in the statute.

(3) The House bill meets the problem of the so-called "preferred stock bail-out" by imposing a penalty tax on a corporation in certain cases when it redeems preferred stock which it has issued as a dividend. While recognizing the serious problem presented by this tax avoidance device, your committee has rejected the House solution which could lead to unjustifiably harsh results. Your committee's solution to the problem is to provide for the taxation of the proceeds of the sale of such preferred stock in certain cases at ordinary income rates.

(4) The House bill combines a new set of rules governing the tax consequences of corporate liquidations. In general, these rules would postpone any tax on unrealized appreciation in corporate assets at the time the corporation is liquidated. This result can sometimes be achieved under existing law but only if an election is made by the shareholders and subject to special safeguards and restrictions. While recognizing the theoretical justification for the rules of the House bill in connection with liquidations, your committee has felt that they should not be adopted at this time. They present certain complexities particularly in the area of the so-called "collapsible corporation" which demand further study. In view of these considerations your committee has returned to the basic pattern of the present Code with, however, certain changes hereinafter noted.

Your committee has also structurally revised the first three parts of the subchapter. Under your committee's bill, part I of the subchapter contains rules primarily devoted to the treatment of current distributions by a corporation, and does not contain rules with respect to distributions pursuant to a recapitalization or other type of reorganization. Part II, as under the House bill, contains rules relating primarily to liquidations. Part III relates only to reorganizations and includes their effects on the shareholders.

The determination of the tax treatment of transactions of the type 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. The provisions in your committee's bill are not intended to disturb the determination in present litigation of a rule of existing law.

A. Corporate Distributions (secs. 301–318)

(1) House changes accepted by committee

Your committee retained, with modifications noted in (2) below, the following provisions of the House bill which revise existing law with respect to corporate distributions:

(a) Allow in general the tax-free distribution of stock and stock rights without regard to a shareholder's proportionate interest before and after the distribution,

(b) Provide a special rule to eliminate negligible basis allocations for stock rights,

(c) Provide special rules to indicate when a redemption of stock will result in a tax at capital gain, rather than ordinary income, rates, (*d*) Broaden the application of the provisions of existing law which relate to the redemption of stock for payment of death taxes,

(*e*) Broaden the rules of existing law to tax as a dividend certain redemptions of stock through the use of related corporations,

(*f*) Tax a corporation which distributes property under certain circumstances,

(*g*) Provide the adjustment to earnings and profits of a distributing corporation where property is distributed in kind, and

(*h*) Provide rules to indicate specific instances when, for purposes of preventing tax avoidance, a person shall be considered to own stock owned by a related person.

(*2*) *Changes made by committee*

(*a*) *Distributions of stock, stock rights and securities.*—Your committee has followed the policy of the House bill allowing the distribution of equity interests in a corporation as a dividend to the greatest extent possible. As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax. Accordingly, the general rule is that no tax is imposed upon the distribution of stock rights and stock dividends whether or not a particular shareholder's proportionate interest in the corporation is varied, but rather is postponed through the application of the pertinent basis provisions. The House bill provides certain exceptions to this basic rule in cases where a distribution of stock, whether pursuant to a reorganization or not, was in lieu of dividend arrearages on preferred stock. Your committee has eliminated the application of this rule in cases where the distribution discharges such arrearages in connection with a recapitalization or other type of reorganization and limits the taxability to stock dividends distributed in lieu of dividends on preferred stock which are in effect currently owing. Your committee continues the rule of the House bill and of existing law that where a shareholder has an election to take a dividend in stock or in cash, the election to take a stock dividend will not prevent the stock being subject to tax.

Your committee has provided a rule to eliminate the necessity under present law of making negligible basis allocations between stock and stock rights issued on such stock. Under this rule, as under the House bill, the basis of the rights will be zero unless the taxpayer elects to allocate or unless the value of the right is 15 percent or more of the value of the stock at the time of distribution, in which event the allocation must be made.

(*b*) *Redemptions of stock.*—Under present law it is not clear when a stock redemption results in capital gain or ordinary income. Some courts have held that a distribution disproportionate to the shareholders' ownership of common stock in the corporation results in capital-gains treatment, but no definite test has developed. While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. This general rule is supplemented by your committee by the rule of the House bill that a redemption which is substantially disproportionate shall also qualify so as not to be taxable as a dividend. In order to qualify a particular shareholder's holdings of common stock after the distribution must be less than 80 percent of his holdings before the distribution. As a further safeguard, your committee has provided that if the shareholder owns a majority of the voting stock before the redemption, he must have less than 50 percent of such stock thereafter.

A distribution in complete redemption of a shareholder's stock will also result in capital gain. However, in order to prevent tax avoidance, your committee follows the rules of the House bill whereby, under specific circumstances, a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates, trusts in which he has an interest). If a shareholder desires to sever completely his interest in a corporation which he and his family controls, the rules of family ownership are waived, as under the House bill, if the shareholder does not reacquire, other than by bequest or inheritance, an interest (other than an interest as a creditor), for a period of 10 years thereafter. However, such a shareholder may not have made or received a gift of stock of the corporation, to or from his wife, for example, within 10 years prior to the distribution. If any interest is reacquired by a shareholder within the prohibited period, an additional tax may be recovered as if the original distribution had been a dividend. Thus modified the family attribution rules will be applied to insure a bona fide severance of a particular shareholder's interest in an enterprise and will not apply where there is no purpose of tax avoidance.

Your committee retains the provisions of existing law allowing stock to be redeemed to pay death taxes without dividend consequences. Your committee's bill includes those provisions of the House bill which would broaden the application of this section. Thus, it allows stock to be redeemed where it not only constitutes 35 percent of the value of the gross estate but also if it constitutes 50 percent of the value of the net estate. Thus, the marital deduction allowed for estate tax purposes will not preclude the availability of this special redemption provision. As under the House bill, the provision also (1) includes funeral and administration expenses as one of the purposes for which stock may be redeemed, (2) extends the time for redemption to 60 days after a decision of the Tax Court concerning the estate tax liability has become final, and (3) allows stock of 2 or more corporations to be redeemed if more than 75 percent in value of the outstanding stock of each corporation is included in the decedent's gross estate with an additional provision to prevent discriminations against estates of decedents in community property States. In order not to preclude the applicability of the provision if stock owned by a decedent is, subsequent to his death, exchanged in a tax-free reorganization, for example, your committee would allow the new stock to be redeemed if the old stock qualified.

Your committee follows the House bill in its retention of the provision of existing law which prevents tax avoidance where a subsidiary corporation purchases stock in its parent from the shareholders of the parent and also extends the provision to include sales of stock between corporations owned by the same interests although the corporations are not in a parent-subsidiary relationship. Under these circumstances it is provided that where the effect of the sale is in reality the distribution of a dividend, it will be taxed as such.

Your committee has also acted to close a possible loophole of existing law known as the "preferred stock bail-out". This is a device by which it is attempted to withdraw earnings from a corporation and pay a tax at rates applicable to capital gains rather than those applicable to dividends. The shareholders cause a dividend in preferred stock on their holdings of common stock to be declared. The dividend stock is then sold. Although it may be subject to immediate redemption by the corporation from the purchaser, such a transaction has been held to give rise to only a capital gains tax on the shareholders at the time of sale. (*Chamberlin* v. *Commissioner* (207 F. 2d 462) *cert. den.* March 8, 1954.) The House bill closed this loophole by imposing, at the corporate level, a transfer tax of 85 percent of the amount distributed in redemption of such dividend stock if the redemption took place within 10 years from the date of distribution. Your committee's approach to this problem imposes a tax on the recipient of the dividend stock at the time of its sale. This dividend stock would be called "section 306 stock" and any stock received as a dividend would be section 306 stock to the extent of its allocable share of corporate earnings at the time of issuance, except common stock issued with respect to common stock.

The tax imposed at the time of the sale of the stock is at ordinary income rates to the extent of its allocable share of earnings and profits of the corporation at the time the stock dividend was declared. Any amount received for the section 306 stock which exceeds the earnings and profits attributable to it will be taxed as capital gain. If, instead of selling the section 306 stock, the shareholder redeems it, the proceeds received will be taxed as a dividend to the extent of corporate earnings at the time of redemption. As under the House bill's solution to this problem, certain exceptions to this basic rule of ordinary income treatment with respect to dispositions of section 306 stock are provided.

Your committee's treatment would be applicable only to issues of preferred stock made after June 18, 1954. The House bill applied to previously issued preferred stock. However, your committee believes that stock issued prior to the effective date of this provision should be treated under existing law.

(*c*) *Current distributions to shareholders and effect on earnings and profits.*—Your committee follows the House bill in retaining the general rules of present law with respect to current distribution by a corporation to its shareholders. Your committee also incorporates into the statute the rule derived from the Supreme Court decision in *General Utilities and Operating Company* v. *Helvering* (296 U. S. 200) that a corporation does not realize gain by reason of a distribution of its property even though the value of the property distributed may exceed its cost to the corporation. Two exceptions are made to this general rule, however, in order to prevent tax avoidance. The first concerns distributions of LIFO inventory. In such cases, the amount of tax deferred under the LIFO method of accounting will be paid by the corporation if the inventory is distributed in kind to shareholders. The second exception imposes a tax where property distributed is subject to a liability in excess of its cost to the corporation.

Your committee follows the House bill in specifying the appropriate adjustment to the earnings and profits of the distributing corporation where there is a distribution of property. This adjustment will be the cost to the corporation of the property distributed. Your committee also follows the House bill in providing for an increase in corporate earnings by the amount of any excess of the fair market value over its cost where inventory items are distributed in kind in order to insure that the shareholder will always pay a tax on the appreciation in value of the inventory.

Your committee has retained the rules of existing law relating to the effect on earnings and profits where there are tax-free distributions and where there are distributions out of increase in value of property accrued before March 1, 1913. The House bill supplied an additional rule for the determination of the manner in which earnings and profits should be allocated where there was a partial liquidation, a corporate separation, or a redemption. Your committee strikes this rule since it is believed that existing administrative practice, making these determinations as the facts of each case may indicate, has been successful in achieving correct results.

Your committee includes a provision, not in the House bill, which is designed to tax distributions of proceeds of loans insured by the United States where the amount of the loan exceeds the cost of the property by which it is secured. This provision is intended to insure the imposition of a tax in the kind of case recently brought to attention in connection with loans made by the Federal Housing Administration. This provision would increase the earnings and profits of the distributing corporation by the amount of the proceeds of the loan in excess of the cost of the property securing it, and would decrease such earnings by the amount of such excess immediately after the distribution. This will have the effect of creating sufficient earnings at the time of distribution so that it may be treated as being made out of earnings and profits, that is, a dividend. Your committee emphasizes in this connection that no implication be drawn from the enactment of this provision with respect to any decision made or litigation pending under present law concerning this subject matter, whether or not such loans are made, guaranteed, or insured by the United States, or with respect to any other provision of this bill which may be relevant to the same subject matter.

B. Liquidations (secs. 331–346)

(1) House changes accepted by committee

Your committee followed the provisions of the House bill in providing that there shall be no gain or loss recognized to a subsidiary corporation in process of liquidation which satisfies an indebtedness to its parent by distributing (in respect of such debt) property which has appreciated in value. Your committee also followed the House bill (with modifications) in its rule which eliminates the necessity of determining whether a corporation in process of liquidation has itself sold its assets or whether the distributee shareholders have made the sale.

(2) Changes made by committee

(a) General rules.—The House bill combined the various liquidation rules of existing law into one provision of general application. This rule involved a deferral of tax on unrealized appreciation in the value of property received and also a carryover of basis in the case of so-

called "appreciated inventory." Your committee has returned to the three basic rules of existing law in its treatment of liquidations. Under the general rule, a shareholder is taxed to the extent of the excess of the fair market value of property received over the cost of his stock. The fair market value of the assets becomes their basis. Where, however, the liquidating corporation is a subsidiary of the distributee corporation, no gain or loss is recognized, and the basis of the property received by the parent corporation is the same as it was in the hands of the subsidiary. Finally, your committee would make permanent the elective provisions of the present code which allow a 1-month liquidation of a corporation to be completed without unrealized appreciation in property being taxed. In the case of an individual, corporate earnings are taxed to the extent of his gain as a dividend, and a corporate shareholder is taxed at capital gain rates on such earnings. This provision has proven useful in the past in permitting the liquidation of personal holding companies.

Under the House bill, a shareholder would in all cases be permitted to receive the purchase price for his stock as his basis for the assets distributed to him regardless of the assets' cost to the corporation. In this respect the principle of *Kimbell-Diamond Milling Company* (187 F. 2d 718) was effectuated. Since the application of the rule of this case is primarily in the area of liquidations by a parent corporation of its subsidiary, the rule has been limited by your committee to liquidations of this type. Accordingly, your committee has provided that where a corporation purchases the stock of another corporation and within 2 years after the purchase a plan of liquidation is adopted, the basis of the assets of the subsidiary received by the parent will be the amount paid for the subsidiary's stock.

(*b*) *Collapsible corporations.*—Under the House bill inventory assets (defined to include certain depreciable business property and rights to future income) which have appreciated in value would retain in the hands of the distributee the basis which such assets had in the hands of the liquidating corporation. This was intended to insure recovery on subsequent disposition by the recipient of a tax measured by difference between the cost and value of the property. Your committee believes that this provision introduces complications into the law and may have the effect of penalizing the unwary purchaser of the stock with a view to liquidating the corporation. Accordingly, your committee has reinstated the rule of existing law with respect to the treatment of collapsible corporations so that a tax at ordinary income rates may be recovered either on sale of the stock or on liquidation of the corporation itself. Under existing law, the provision is not applicable to any shareholder owning less than 10 percent of the outstanding stock of the collapsible corporation. In order to prevent avoidance of this section, it is made applicable to any shareholder owning more than 5 percent of the outstanding stock. Your committee also provides a presumption that a corporation is a collapsible corporation where 50 percent or more of the fair market value of its assets constitute inventory which has appreciated in value by at least 20 percent over its original cost.

(*c*) *Court Holding Company.*—Your committee follows the House bill in eliminating questions arising as a result of the necessity of determining whether a corporation in process of complete liquidation made a sale of assets or whether the shareholder receiving the assets made the sale. Compare *Commissioner* v. *Court Holding Company* (324 U. S. 331) with *U. S.* v. *Cumberland Public Service Company* (338 U. S. 451). This last decision holds that if the distributee actually makes the sale after receipt of the property, there will be no corporate tax on the sale. The result of these two decisions is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary.

Your committee provides that if a corporation adopts a plan of liquidation and liquidates within 12 months thereafter, sales of assets during this 12-month period will not result in tax at the corporate level. The House bill provides an exception to this rule where sales were made of so-called appreciated inventory. Your committee allows the nonrecognition of gain at the corporate level even if inventory is sold but requires that the inventory must be sold in bulk. This more nearly corresponds to the results that would follow a sale of all the corporate assets (including the inventory) and the sale of all the stock.

(*d*) *Partial liquidation.*—Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.

Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in part I of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation.

The general language of the proposed draft would include within the definition of a partial liquidation the type of cases involving the contraction of the corporate business. Such as for example, cases which hold that if the entire floor of a factory is destroyed by fire, the insurance proceeds received may be distributed pro rata to the shareholders without the imposition of a tax at the rates applicable to the distribution of a dividend, if the corporation no longer continues its operations to the same extent maintained by the destroyed facility. Voluntary bona fide contraction of the corporate business may of course also qualify to the same extent as under existing law. In addition to the general definition of what constitutes a partial liquidation, your committee's bill provides a rule to indicate one type of distribution that will in any event constitute a partial liquidation. Under this rule, if a corporation is engaged in two or more active businesses which has been carried on for at least 5 years, it may distribute the assets of either one of the businesses in kind, or the proceeds of their sale.

C. Corporate Organizations and Reorganizations (*secs. 351–373*)

(*1*) *House changes accepted by committee*

Under existing law, in the case of the organization of a corporation, the interest of the shareholders or securityholders in the corporation after the transfer of property to it must be in substantially the same proportion as their respective interests in the property prior to the transfer in order to avoid the recognition of gain or loss on the entire transaction. It is often impossible accurately to value the property transferred, and accordingly, this requirement has resulted in uncertainty. Your committee follows the House bill in eliminating this requirement. However, any substantial disproportion resulting in a shift of interest between the persons contributing money or other property will be subject to tax either as a gift or as compensation, as the facts of the case may indicate.

While your committee has rewritten the provisions of the House bill relating to corporate reorganizations, it has retained (with modification) certain substantive changes made therein. These are:

(*a*) allowing in certain cases the tax-free distribution of stock of a subsidiary corporation directly to the shareholders of its parent, whether or not such distribution is pro rata to their holdings of stock in the parent;

(*b*) broadening the definition of the consideration which may be received in certain corporate acquisitions;

(*c*) retaining the concept of matching principal amounts where securities are surrendered and received in connection with a corporate reorganization;

(*d*) retaining existing law relating to insolvency reorganizations.

(*2*) *Changes made by committee*

(*a*) *Corporate separations.*—The principal changes in existing law made by your committee are made in the provisions dealing with the tax consequences of the separation of an existing corporation. These changes correspond substantially to those made in the House bill. Under existing law, a corporation may transfer part of its assets to a newly created corporation, if immediately after the transfer, the transferee corporation is controlled by the transferor or its shareholders. This requirement that only stock of a transferee corporation may be distributed has been eliminated. Thus, a corporation may distribute the stock of an existing subsidiary tax free to its shareholders, and it will not be necessary, as at present, to create an intermediate holding company.

In addition your committee follows the House bill in providing that a transferee corporation may be controlled by persons who were shareholders of the transferor. For example, if individuals A and B transfer their separate sole proprietorships to a corporation in which each receives 50 percent of the stock, these businesses may again be separated but into corporate entities, one of which may be wholly owned by A and one by B. As in the case of the organization of a corporation, a disproportionate distribution which has the effect of a gift or of the payment of compensation will be subject to tax as such.

Present law contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business. Under the House bill, it is immaterial whether the assets are those used in an active business but if investment assets, for example, are separated into a new corporation, any amount received in respect of such an inactive corporation, whether by a distribution from it or by a sale of its stock, would be treated as ordinary income for a period of 10 years from the date of its creation. Your committee returns to existing law in not permitting the tax free separation of an existing corporation into active and inactive entities. It is not believed that the business need for this kind of transaction is sufficiently great to permit a person in a position to afford a 10-year delay in receiving income to do so at capital gain rather than dividend rates. Your committee requires that both the business retained by the distributing company and the business of the corporation the stock of which is distributed must have been actively conducted for the 5 years preceding the distribution, a safeguard against avoidance not contained in existing law.

(*b*) *Receipt of additional consideration.*—Where a recapitalization or other type of corporate reorganization occurs, a shareholder may receive money or other property, known as "boot," in addition to the stock or securities which may be received without the recognition of gain. Your committee's bill follows the House bill and existing law in not disqualifying the transaction as a whole as a tax-free exchange, but the "boot" is subject to tax. Under the House bill, if the distribution is otherwise to be taxed as dividend, it will be taxed as such regardless of whether the shareholder had a gain on the transaction as a whole. Your committee returns to existing law in taxing a dividend only to the extent of the amount of "boot" received which is not in excess of the particular shareholder's gain. Thus, if a shareholder surrenders stock which has a basis of $100 in his hands in a recapitalization and receives in exchange stock which has a value of $50 and a bond with a value of $75, the entire amount of the bond would be considered as "boot" but only $25 would be subject to tax since this is the amount of his gain realized on the transaction.

Where securities are exchanged for securities, your committee follows the House bill in expanding the principle of *Commissioner* v. *Neustadt's Trust* (131 F. 2d 528) to the effect that no gain or loss is recognized where the securities received are in the same principal amount as the securities surrendered. Where the principal amounts of securities received and surrendered vary, the Neustadt rule is applied to so much of the principal amount of the bonds received as is equal to the amount surrendered. Thus, if a shareholder surrenders a bond in the principal amount of $150 in exchange for a bond in the principal amount of $200, the draft treats the exchange as if there had been a tax-free exchange of a bond in the principal amount of $150 for a bond of identical principal amount and the receipt of an additional bond in the principal amount of $50. The fair market value of this $50 would be taken into account in determining whether there has been a receipt of taxable boot.

(*c*) *Definition of corporate reorganization.*—Your committee has eliminated the distinctions in the House bill between the types of tax-free reorganizations which may be entered into by corporations which are publicly held, and those which are closely held.

Your committee has retained two significant changes in the rules relating to corporate reorganizations which appear in the House bill. It is there provided that when substantially all the assets of one corporation are acquired by a corporation which is a subsidiary, the shareholders of the transferor may receive the voting stock of the parent of the acquiring subsidiary corporation in exchange for their stock. Existing law would require that only voting stock of the subsidiary may be received in such a case (*Groman* v. *Commissioner* (302 U. S. 82); *Helvering* v. *Bashford* (302 U. S. 454)). Your committee extends the rule of the House bill to include a case where the parent corporation receives the assets in a statutory merger or consolidation and immediately transfers part or all of the assets to a subsidiary.

The second change made by the House bill which is retained by your committee in a modified form permits one corporation acquiring substantially all the assets of another in exchange for its stock to exchange stock for 80 percent of the assets and to acquire the balance for property other than such stock. The restriction of existing law that only stock of the acquiring corporation may be exchanged for assets acquired introduces difficulties in completing transactions where certain shareholders of the transferor corporation may wish to receive property instead of stock in the continuing corporation. However, your committee has returned to existing law by requiring that the qualifying stock in question be voting stock.

D. Carryovers to Successor Corporations (sec. 381)

(1) House changes accepted by committee

The House bill provides that the major tax benefits, privileges, elective rights, and obligations of one corporation will carry to successor corporation when the assets of two or more predecessor corporations are combined in a tax-free liquidation or reorganization. These include such items as loss carryovers, unamortized bond discount, installment sales reporting, LIFO inventory method, and earnings and profits.

Present practice rests on court-made law which is uncertain and frequently contradictory. Your committee agrees that whether or not the items carryover should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization.

The bill provides for the carryover of these tax attributes or items from one corporation to another in certain tax-free liquidations and reorganizations. Under this provision, a corporation which acquires substantially all the property of another corporation in a tax-free distribution or transfer is to take into its accounts the specified items of the distributor or transferor corporation. The section does not apply in the case of split-ups, spin-offs, or other divisive reorganizations.

The new rules enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law. Tax results of liquidations or reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise. At the same time the new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as liquidation and reincorporation or merger into another corporation.

(2) Changes made by committee

Your committee added two items to the list of those in the House bill. These are (1) the deduction of deficiency dividends in the case of personal holding companies, and (2) percentage depletion with respect to mine tailings.

E. Special Limitation on Net Operating Loss Carryover (sec. 382)

(1) House changes accepted by committee

Under present law where a controlling interest in a corporation is acquired for the purpose of avoiding or evading tax liabilities the Internal Revenue Service may disallow the benefits of a deduction, credit, or allowance which would otherwise be enjoyed by the acquiring person or corporation. This provision has proved ineffectual, however, because of the necessity of proving that tax avoidance was the primary purpose of the transaction. It has also been so uncertain in its effects as to place a premium on litigation and a damper on valid business transactions.

The House bill added a provision designed to limit undue tax benefits of this character by restricting the amount of net operating loss carryover which may be deducted where 50 percent or more of the participating interest in a corporation was acquired by new owners. Your committee adopted this provision with modifications noted below.

(2) Changes made by committee

Your committee has adopted a provision to limit the application of this provision relating to purchase to those areas in which abuse has most often arisen, that is, the purchase of the stock of a corporation with a history of losses for the purpose of using its loss carryovers to offset gains of a business unrelated to that which produced the losses. Accordingly, your committee has provided that if more than 50 percent of the stock of a corporation is purchased within a 2-year period and if the corporation thereafter engages in a different type of business, then the loss carryover is eliminated.

Your committee also limits the allowance of net operating loss carryovers as a result of a tax-free reorganization. Your committee considers it appropriate to allow such carryovers in full only when the shareholders of the predecessor loss corporation have a substantial continuing interest in the successor corporation. Thus, if the shareholders of the old loss corporation have 20 percent of the stock of the new corporation the loss carryover is available to the new corporation without diminution. The amount of the carryover is reduced proportionately, however, if the old shareholders receive less than this percentage. Thus, if they have only 10 percent of the stock in the successor corporation, only 50 percent of the loss carryover is available to it.

XIII. Pension, Profit-Sharing, and Stock Bonus Plans

The House bill made a major departure in the qualification requirements for pension, profit-sharing, and stock bonus plans. The aim was to replace the Commissioner's discretion under present law with clear rules that would permit any employer to determine whether or not a plan was qualified and to do so in a way that would qualify all reasonable plans without opening the door to discriminatory plans. These broad objectives have received general approval. However, the mechanical rules in the House bill have raised many problems for many different types of plans. In view of the difficulty of developing adequate mechanical tests to meet these problems your committee's bill retains the framework of the present treatment of pension, profit-sharing and stock bonus plans pending further study.

Certain changes, however, most of which are in the House bill, are adopted.

A. Capital Gains on Lump-Sum Distributions (secs. 402 (a) (2), (3), (e), and 403 (a) (2))

(1) House changes accepted by committee

Under present law lump-sum distributions made by qualified trusteed plans to employees because of separation from service are taxed as long-term capital gains. However, capital gains treatment is not granted to similar lump-sum distributions made under qualified insured plans. In addition, whether the plan is insured or trusteed, lump-sum distributions made to the beneficiary of an employee who dies after retirement are taxed as ordinary income.

Your committee's bill adopts the provisions of the House bill which are designed to eliminate this discriminatory treatment. Capital gains treatment is extended to lump-sum distributions made to employees because of separation from service under qualified insured plans as well as under trusteed plans. In addition, for both insured and trusteed plans, capital gains treatment is extended, as in the House bill, to lump-sum distributions made to beneficiaries of employees who die after retirement.

(2) Changes made by committee

The House bill extends capital gains treatment to lump-sum distributions to employees at the termination of a plan because of a complete liquidation of the business of the employer, such as a statutory merger, even though there is no separation from service. This was intended to cover, for example, the situation arising when a firm with a pension plan merges with another firm without a plan, and in the merger the pension plan of the first corporation is terminated.

Your committee's bill revises this provision of the House bill to eliminate the possibility that reorganizations which do not involve a substantial change in the make-up of employees might be arranged merely to take advantage of the capital gains provision. Thus, your committee's bill would grant capital gains treatment to lump-sum distributions occurring in calendar year 1954 where the termination of the plan is due to corporate liquidation in a prior calendar year. The purpose of granting capital gains treatment to such distributions is to avoid hardship in the case of certain plans which it is understood were terminated on the basis of mistaken assumptions regarding the application of present law.

B. Profit-Sharing and Certain Stock Bonus Plans of an Affiliated Group (sec. 404 (a) (3) (B))

(1) House changes accepted by committee

Under existing law a group of corporations may establish a common profit-sharing plan, but there may be no shifting of contributions or deductions among the group. For example, a member of the group with no profits in a given year and no accumulated earnings could not make a contribution to its plan, and no other member of the group could make the contribution on its behalf.

Under the House bill, and under your committee's bill, if a profit-sharing plan is established by a group of corporations which is affiliated, as defined for purposes of filing consolidated returns, and a member of the group is prevented from making a contribution because it has no profits, the contribution could be made, for the benefit of the employees of the loss corporation, by the members with profits.

(2) Changes made by committee

Your committee's bill accepts the House provisions but makes two further changes which appear meritorious. The first change would extend this provision to stock bonus plans where the contribution is measured as a percentage of profits. In such a case the conditions are precisely like those which led to the adoption of this provision for profit-sharing plans. The second change would eliminate the requirement that the contributions on behalf of a loss member be divided up among the profit members of the group in proportion to their profits where a consolidated return has, in fact, been filed. The House amendment would have required the members of the group to divide up the contribution so that each would make up that proportion of the contribution for the loss member which its profits bear to the total profits.

C. Deduction for Employers on Accrual Basis (sec. 404 (a) (6))

(1) House changes accepted by committee

Under present law a taxpayer on the accrual basis is deemed to have made a contribution to an employee plan in the year of accrual provided he actually makes payment within 60 days after the close of that year. Taxpayers have complained that the 60-day period is too short in view of the complicated actuarial computations required in determining the actual amount of the contribution. Your committee's bill accepts the House provision to extend this period from 60 days to the date for filing the tax return (including any extensions). This, in effect, would extend the time period for actual payments from 60 days to 75 days after the close of the taxable year plus any extensions of the filing date.

(2) Changes made by committee

Your committee made no change in this provision.

D. Distributions in Employer Securities (sec. 402 (a) (1) and (3) (B))

(1) House changes accepted by committee

Existing law, in certain cases, postpones tax on the gain on employer securities distributed by an employees' trust.

The House bill and your committee's bill continue the present treatment.

(2) Changes made by committee

Present law and the House bill define securities of the employer to include, for example, securities of another corporation more than 50 percent of the stock of which is owned by the employer. Cases have been brought to the attention of the committee where two corporations each own exactly 50 percent of the stock of a third corporation and, therefore, the stock of the third corporation cannot qualify as employer securities. Relief is granted in such cases by changing the "more than 50 percent" ownership requirement to "50 percent or more" which is done in section 421 (d) (2) and (3) which defines employer securities for purposes of the rules relating to restricted employee stock options. As under present law, the stock option definition is applied for purposes of employee trust distributions.

E. Certain Negotiated Plans (sec. 404 (c))

(1) House changes accepted by committee

The House bill did not make explicit provision in this area.

(2) Changes by committee

Under present law, certain plans established as a result of negotiation with unions do not constitute qualified plans because they do not segregate pension funds from funds used for other purposes and do not satisfy other rules required for qualification. This may have the result of denying employers deductions for contributions to such plans because present law, which is retained by your committee, does not allow deductions for contributions to nonqualified plans where employees' rights are forfeitable.

Your committee feels that this denial of deductions for employer contributions is inequitable where a negotiated plan was established during a period of Government operation. Your committee's bill therefore provides that employers shall be entitled to deduct as business expenses contributions made to plans established before January 1, 1954, which are the result of an agreement between employee representatives and the United States Government during a period of Government seizure and operation of most of the productive facilities of the industry. This provision does not appear in the House bill.

F. Foreign Situs Trust (sec. 402 (c) and 404 (a) (4))

(1) House changes accepted by committee

Under existing law the Revenue Service rules, with one exception, that a foreign situs employees' trust cannot qualify as an exempt employees' trust. The exception is that a foreign situs trust established by an American employer may qualify if the trust agrees to make no investments which will produce United States source income. This investment limitation is imposed because otherwise the United States source income would not be taxed to the trust and also would often escape tax in the hands of beneficiaries.

Your committee's bill adopts the House provision which specifically prevents all foreign situs trusts from qualifying as exempt trusts. While this change subjects the foreign situs trust of an American employer to tax, it has the advantage of allowing such trusts to make investments which produce United States source income. As in the House bill, the harsh results of denying an American employer a deduction for his contributions to all foreign situs trusts is avoided by allowing contributions to be deducted where the trust would have qualified for exemption if it had been a domestic trust.

(2) Changes made by committee

At present, capital gains treatment is granted to lump-sum distributions on termination of service in the case of a foreign situs trust of an American employer, in view of the Revenue Service position that such a trust may qualify. The House bill makes no provision for treating any lump-sum distributions by foreign service trusts as capital gains. Your committee's bill would allow capital gains treatment where the trust would qualify, except for the fact that it is a foreign situs trust.

G. Information Returns (sec. 6033)

(1) House changes accepted by committee

Section 6033 of the House bill requires tax-exempt organizations, including qualified trusts, to file annual information returns. Your committee's bill adopts this procedure.

(2) Changes made by committee

At present, if the employer company has filed all of the required information with its tax return an employee's trust is not required to duplicate such information on a separate return but, instead, is permitted to file a letter from the employer stating that the employer has so filed. However, the House provision would appear to make it mandatory for the trust to file information even though it duplicates information filed by the employer. Your committee's bill authorizes the Commissioner to relieve the trust from stating in its return any information which is reported in returns filed by the employer. It also makes it clear that any returns which are filed under section 6033 start the running of the period of limitations.

H. Tax on Unrelated Business Income of Employees' Trusts (secs. 511, 512, 513, and 514)

(1) House changes accepted by committee

Your committee's bill adopts the House provision which makes employees' stock bonus, pension, and profit-sharing trusts subject to the tax on unrelated business income.

(2) Changes by committee

Your committee made two further changes designed to prevent hardship in the application of the tax on a portion of the rental income which is determined with reference to the amount of the indebtedness of the trust which was incurred to acquire or improve the leased property. First, your committee provides that where loans are made by one trust to another trust of the same employer, subject to appropriate limitations, such borrowed funds will not be treated as indebtedness for purposes of the tax on rental income. Second, any debt incurred by an employees' trust in connection with real property leased before March 1, 1954, shall not be considered as indebtedness if the debt is incurred before March 1, 1954, or after this date, in order to carry out the terms of the lease.

I. Prohibited Transactions (sec. 503)

(1) House changes accepted by committee

Your committee's bill adopts the House provision which denies a stock bonus, profit-sharing, or pension-trust exemption from tax if it engages in a prohibited transaction after March 1, 1954. For example, if the trust loaned any part of its income or corpus to the employer-creator of the trust without the receipt of adequate security and a reasonable rate of interest, or if its property is purchased from the employer for more than its adequate value, the trust would lose its exempt status.

(2) Changes made by committee

Your committee has adopted a special rule to modify the sudden impact of this provision on employees' trusts which have previously made loans without adequate security. A sudden requirement for repayment could cause considerable difficulty for the borrower, usually the employer. If such a loan has been made before March 1, 1954, and is payable before December 31, 1955, it may be extended to that date. If the loan is a demand loan, the mere continuance after December 31, 1955, will be a prohibited transaction even if it was entered into before March 1, 1954.

J. Denial of Exemption (sec. 504)

(1) House changes accepted by committee

The House bill would have denied exemptions to employees' trusts, if amounts accumulated out of income are invested in such a manner as to jeopardize the carrying out of the purpose or function constituting the basis for its exemption. This amendment was not accepted by your committee.

(2) Changes made by committee

Because this section relates only to amounts accumulated out of income, it has little application to pension, profit-sharing and stock-bonus trusts whose assets are primarily of amounts accumulated out of employer contributions. Your committee's bill therefore deletes the amendment to existing law in the House bill especially since the principal purpose of the amendment is substantially served by section 401 (a) (2) (comparable to sec. 165 (a) (2) of existing law), which provides that no part of the corpus or income of an employees' trust be used or diverted to purposes other than the exclusive benefit of employees or their beneficiaries prior to the satisfaction of all liabilities with respect to employees and their beneficiaries.

XIV. Employee Stock Options (Sec. 421)

(1) House changes accepted by committee

The revenue bill of 1950 established a new set of rules for the tax treatment of certain employee stock options. As a result of this act "restricted stock options" can be used as incentive devices by corporations who wish to attract new management, to convert their officers into "partners" by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation. When an option qualifies as a "restricted stock option" no tax is imposed at the time the option is granted or exercised. Instead the tax is deferred until the stock is sold and at that time if certain conditions are met any gain realized is a capital gain.

Before the Revenue Act of 1950, the Internal Revenue Service held that the employee was taxable at the time he exercised the option and at that time had ordinary income to the extent the difference between the market value of the stock at the time of exercise and the purchase price of the stock under the option.

The House and your committee's bill retain the present "restricted stock option" provision but makes certain changes to eliminate ambiguities, to provide more definite rules with respect to problems raised since this provision was first enacted and to further the use of stock options as incentive devices.

Under present law the tax treatment of the exercise of a "restricted stock option" after the death of an employee is not provided for even though "restricted stock options" are transferable by will. It is believed that the untimely death of an employee should not penalize his estate or beneficiaries by denying an option the status of a "restricted stock option" merely because of the employee's death. For that reason both versions of the bill provide that the exercise of "restricted stock options" by the estate or beneficiary of a deceased employee is to have the same tax effect as if the employee had exercised the option (for an additional change made by your committee in this area, see No. 2, below). In addition, the estate tax attributable to the inclusion of the option in the decedent's estate is to be allowed as a deduction for income-tax purposes in the year in which the estate or beneficiary has an increased income as a result of disposing of the stock acquired under the option.

A further clarification provides that variable price options may qualify as "restricted stock options." A variable price option is an option in which the price to be paid by the employee for the stock is determined by reference to the market value of the stock, for example, an option permitting an employee to purchase stock at 85 percent of the value of the stock. The variable price option was not easily adaptable to the statutory language of present law because the existing provision appears applicable only to an option which stipulated its option price in dollars and cents. It is believed that variable price options should be able to qualify as "restricted stock options" since they are widely used by corporations to encourage the interests of their employees in the affairs of their business. Therefore, both versions of the bill provide that these options are to qualify as restricted stock options if the option price is within 85 percent of the value of the stock at the time the option was granted, and the other qualifications of restricted stock options are met. A change your committee made in the House definition of a variable option is described below.

Under present law if an employer corporation is reorganized in a tax-free exchange and an employee has already exercised his option no "disposition" occurs upon the exchange of his stock. Thus, he is not at that time taxable on any gain resulting from the exercise of the option. However, when the reorganization occurs before the employee has exercised his option it is not clear that he still has a "restricted stock option" if the reorganized corporation assumes responsibility for the old option or issues a new one. The House bill allows a successor corporation to be considered as the employer corporation and provides that the change in the terms of an option to comply with a reorganization are not to be considered a modification. As is explained in the report on the House bill the preservation of the employee's rights in such a case appears desirable because the reorganization is not an event the employee can control. Your committee's bill as is explained below preserves the "restricted stock option" status of the option not only in the case of reorganizations but also in the case of other corporate changes.

Both versions of the bill also provide that any options granted in the future in order to qualify as restricted stock options may only be exercisable over a period of 10 years or less. This action was taken because options granted over a longer period of time are almost certain to benefit the employee even if there is no action on his part to increase the success of his employer.

Under present law a person who owns more than 10 percent of the stock in his employer corporation cannot receive a "restricted stock option." This is intended to prevent abuses where the corporation is closely held. However, the attention of the House and your committee has been directed to cases of stockholder-employees of closely held corporations who use stock options to retain control of their company when procuring outside equity financing. This use of stock options appears to be a legitimate business purpose and where the option price is substantially above the market price of the stock and the option may be exercised only for a limited time it would appear that the options in these cases are not intended as compensation. As a result both versions of the bill provide that if the option price at the time the option is granted is at least 110 percent of the value of the stock and the option is exercisable over a period not exceeding 5 years an employee, even though owning more than 10 percent of the stock of his employer, can receive a "restricted stock option." A further change made by your committee in this area is discussed below.

The regulations under present law relating to the acquisition or transfer of stock acquired under a "restricted stock option" in joint tenancy have been incorporated in the new law. This is believed desirable in order to insure that stock acquired in common-law States may be owned jointly without incurring a tax liability.

Under present law when stock acquired under a "restricted stock option" is disposed of prior to 2 years from the date the option was granted or 6 months from the date the stock was acquired, the past returns of the employee and the employer for the year the option was exercised must be reopened to tax the employee and allow the employer a deduction for any difference between the option price and the value of the stock at the time the option was exercised. The House and your committee's bill provide that any necessary adjustments are to be made in the year the stock is sold. This eases the administrative problems presented by existing law.

The House bill also revised the rules for restricted stock options where there have been modifications, extensions, or renewals. However, since your committee also made substantial changes in this area the entire problem is discussed below.

(*2*) *Changes made by committee*

The House provision treating an option exercised by an estate or beneficiary of an employee in substantially the same manner as if the option were exercised by the employee, while desirable and approved by your committee, has created another problem. Where stock acquired by an estate by exercising an option, is transferred to a beneficiary this event does not qualify as a "disposition" under present law or the House bill and, therefore, there is no event at which time ordinary income is reported for tax purposes on options issued at a price between 85 and 95 percent of the value of the stock. As a result your committee has provided that the transfer to a beneficiary of stock acquired by an estate upon the exercise of an option is to be treated as a "disposition" for purposes of reporting ordinary income in the case of the options described above.

A "variable price" option is defined under the House bill as an option where the purchase price of the stock under the option is not fixed or determinable. It has been pointed out to your committee that this might create a loophole by covering options where the option price decreases as the value of the stock increases. For example, under the House provision it appears that an option would qualify where the option price decreases as the corporation's accumulated earnings increase. To close this loophole your committee has provided that in variable options the value of the stock is to be the only variable.

In determining the corporate organizational changes which may occur without disqualifying an option as a "restricted stock option," your committee's bill takes a broader approach to the problem than the House bill. Your committee has provided that in the case of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation where there has been a substitution of a new option for an old option (or where the old option has been assumed by the new employer) the old option is to be considered as continuing in effect. Your committee found it possible to provide this more liberal approach by requiring two conditions to be met in these cases. The old option must be canceled (unless it is assumed and no new option issued) and the value of the new option must not be greater than that of the old option. In addition, as also is provided by the House bill, the new option must not give additional benefits not available under the old option.

Both the House and your committee's bill also made changes in the rules applying in the case of the modification, extension or renewal of an option. Under present law the modification, extension or renewal of an option requires that the option price not be reduced unless the value of the stock has increased since the option was granted. This is detrimental to employees having options in stock where the value of the stock has decreased. The House bill provided that if the option was granted after December 31, 1953 or was exercisable over a period of 10 years or less the earlier value of the stock would not control the option price at the time of any modification, extension or renewal. It also, for options issued in 1954 and subsequent years, defined a "modification" as any change which improves the position of the employee under the option but excluded from this term any changes in the option attributable to a change in the corporate structure of the employer corporation. The House bill also provided that a change in an option to make it both nonassignable and exercisable over a 10-year period or less was not to be considered a modification in the case of options issued after February 26, 1945, the effective date for restricted stock options under the Revenue Act of 1950.

Your committee, while approving in general of these changes made by the House bill, believes that employees should not be permitted to take advantage of temporary price declines in the stock to obtain a more favorable option. For that reason it has provided that the earlier price will apply unless there has been a decline of at least 20 percent in the value of the stock for a year or more. With this change your committee sees no reason to distinguish between options issued before or after December 31, 1953. Thus, under your committee's bill the new option price is available in the case of modifications in the case of pre- and post-1954 options. The changes in the definition of "modification" made by the House were retained by your committee.

The House bill provided that where an option is granted at 110 percent of the value of the stock and is exercisable only in a 5-year period, the 10 percent stock-ownership provision does not need to be met. Your committee accepted the House provision but has waived the 5-year period for the exercise of the option where the option actually is exercised within 1 year after the enactment of this bill. This appears desirable in that in the case of existing options there was no way of knowing at the time the option was issued that a 5-year restriction would be imposed by this bill for the exercise of these options.

Your committee has also made certain other technical changes. These include changing from December 31, 1953, to June 18, 1954, the effective date of the provision requiring options in order to qualify as "restricted" to provide a 10-year period in which they can be exercised and changing the requirements under the definitions of parent and subsidiary corporations from those owning more than 50 percent of the stock of another corporation to those owning 50 percent or more of such stock.

XV. Accounting Provisions

Present law provides that the net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed by the taxpayer, if such method clearly reflects the income, and the regulations state that approved standard methods of accounting will ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income.

The changes embodied in the House bill and in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and to assure that all items of income and deductions are to be taken into account once, but only once in the computation of taxable income.

A. Prepaid Income (sec. 452)

(1) House changes accepted by committee

Under present law payments received in advance for the use of property in future years or for services to be rendered in future years are includible in the income of the recipient in the year they are received. This is true regardless of the taxpayer's method of accounting. However, well-established accounting procedure provides that in the case of those on an accrual accounting system payments for rentals, club dues, warehouse fees, and the like should be included in income in the year in which the income is earned and in the year in which the related expenses are incurred. This is not necessarily the year of receipt.

The House and your committee's bill permit accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned. However, both bills provide that the period over which the prepayments may be deferred cannot exceed 5 years after the year of receipt. This limitation will not affect the great majority of prepayments which are earned within 5 years, but will reduce substantially the administrative work.

Where amounts are received in advance and are not to be earned within the 5-year period, taxpayers who have so elected are to take the prepayments into account ratably over the period of the taxable year of receipt and the 5 succeeding taxable years. With the consent of the Secretary or his delegate, however, the taxpayer may allocate the income in another manner.

Where a taxpayer dies or where, for any other reason, the liability with respect to the deferred income ceases, the prepayments not previously reported as income become taxable in the year in which such an event occurs.

The election provided in this provision is available only with respect to advance payments received by a taxpayer in a taxable year beginning after December 31, 1953.

(2) Changes made by committee

The House bill leaves in doubt the status of amounts received in advance which are to be earned over an indefinite period. Your committee's bill includes a clarifying amendment which provides that such amounts (e. g., tickets or tokens redeemable indefinitely) may be classified in part as income to be earned over a short period and allocated to income in the year or years proper under the taxpayer's method of accounting, and in part as income to be earned over a period in excess of 5 years, on the basis of a reasonable estimate, in accordance with regulations prescribed by the Secretary or his delegate.

B. Reserve for Estimated Expenses (sec. 462)

(1) House changes accepted by committee

Under present law deductions for expenses and losses incurred by a taxpayer may be taken only when all events have occurred which fix the fact and the amount of the taxpayer's liability. This, in many cases, is at variance with generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account.

The House and your committee's bill conform the tax treatment of expenses more closely to general business treatment by permitting an accrual-basis taxpayer to deduct reasonable additions to reserves for estimated expenses. The expenses must be related to income taxed during the year (except for adjustments or corrections of previously established reserves) and must be allowable deductions which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy. A reserve is to be considered reasonably estimated when it is based on reliable data or statistical experience of the taxpayer or of others in similar circumstances. Reserves for general contingencies, indefinite future losses, or for amounts in litigation do not fall in this category.

At the end of each year these reserves are to be adjusted to reflect the best estimate currently available; any amount by which a reserve is found to be excessive is to be taken into account in the year of determination.

The election to establish reserves for estimated expenses is not available with respect to any deduction attributable to income reported in a taxable year beginning before 1954, or to prepaid income which the taxpayer has elected to defer.

(2) Changes made by committee

Your committee amended the House bill to provide that additions to reserves are to be taken into account in the discretion of the Secretary or his delegate in order to conform the administrative control in this area with the control provided under section 166 relating to reserves for bad debts. Your committee also added a specific provision to the effect that expenses estimated under this section must be attributable to income taxed during the current year or to income of preceding years for which reserves under this section had been established.

The House bill was silent on the status of deductions for expenses attributable to taxable years prior to 1954 but actually incurred subsequent thereto. To clarify any uncertainty in this area your committee's bill provides that expenses incurred in 1954 and subsequent years which pertain to the income of taxable years preceding the first year of election under this section may be deducted as though this section had not been enacted.

C. Initial Payment Before Use of Installment Method (sec. 453 (b))

(1) House changes accepted by committee

Under present law, in order to use the installment method of reporting income in the case of sales of real property or casual sales of personal property some payment must be made in the year in which the sale occurs. There have been many legitimate transactions which could not be reported under the installment method merely because there was no payment in the year of sale.

The House and your committee's bill provide that in the future in the case of a sale of real property or a casual sale of personal property there need be no payment made in the taxable year in which the sale occurs.

(2) Change made by committee

The House bill required that in the year in which payments were first received, such payments could not exceed 30 percent of the selling price. This requirement would leave in doubt, for perhaps a number of years, the status of certain sales in which the intital payments are indefinite and are not payable until some time subsequent to the year of sale. Your committee's bill, therefore, provides that sales of realty and casual sales of personalty, which otherwise qualify, may be reported under the installment method if in the year of sale either no payments are received, or the payments in that year do not exceed 30 percent of the selling price.

D. Change of Method From Accrual to Installment (sec. 453 (c))

(1) House changes accepted by committee

Under present law a taxpayer who changes his accounting method from the accrual basis to the installment basis pays a double tax on certain income. Under the accrual method the entire profit from a sale is taken into account in the year of sale, regardless of when the collection is made. Under the installment method, the profit from a sale is recognized piecemeal as the cash is collected. In the early years following a change from the accrual to the installment method, present law taxes portions of the profit realized from all installment collections including profits in collections on sales made before the change which previously had been reported as taxable income under the accrual method.

The House and your committee's bill provide that a taxpayer shifting from the accrual to the installment method of accounting is not to be taxed twice on the same income. The tax attributable to an amount included in income for the second time is eliminated or is at least decreased to the extent of the tax attributable to its inclusion under the earlier method of accounting.

(2) Changes made by committee

None.

E. Other Changes in Methods of Accounting (sec. 481)

(1) House changes accepted by committee

At present taxpayers who request permission to change their method of accounting (other than to the installment method), or to change the manner in which they compute significant items such as inventories, are required to make certain adjustments in the year of the change. These transitional adjustments are necessary to prevent income and expenses from being reported for tax purposes more than once and to prevent the omission of certain income entirely. Under certain circumstances, however, where a change in accounting method is made involuntarily, the courts have denied the Internal Revenue Service the right to require these adjustments. In other cases where the adjustments are made, the tax resulting from a "bunching" of income in the year of change is a burdensome one for the taxpayer.

The House bill and your committee's bill provide an averaging device where the taxpayer has had at least 2 years' experience under the old method of accounting and where the transitional adjustments result in an increase in taxable income of more than $3,000 in the year of the change. The averaging device to be used provides that the tax resulting from the change is limited by the tax that would result if the net transitional adjustment were spread evenly over the year of the change and the 2 preceding years.

Your committee retained the feature in the House bill that authorizes the taxpayer to take into account the transitional adjustments in any manner, and in any years, prior or subsequent to the year of change, agreed upon with the Secretary or his delegate in accordance with regulations.

(2) Changes made by committee

The House bill would have required taking into account the entire transitional adjustment determined by the Secretary or his delegate to be necessary to prevent duplicating items of income and deductions under the new method of accounting. Your committee felt that permitting the entire adjustment would result, in effect, in adjusting for errors which occurred during years when there was no statutory authority for making such adjustment. The results under the House bill would be harsher on taxpayers in most instances of involuntary change than the results of recent court decisions. Therefore, your committee's bill provides that the portion of the net transitional adjustment which corrects errors made prior to 1954 will not be made.

The transitional adjustments in all future changes under your committee's bill will be those resulting from a change in accounting method determined (under the facts) to be necessary to adjust for erroneous treatment of items subsequent to 1953.

In addition, your committee's bill provides another limitation on the tax liability resulting from a change in accounting method. The tax resulting from a change is limited to the aggregate of taxes which would result from allocating the adjustments to years prior to the year of change (but subsequent to 1953) by recomputing taxable income for those years under the new method of accounting. This limit on tax liability will be effective only to the extent that the records of the taxpayer are adequate to permit such recomputation.

F. Accrual of Real Property Taxes (sec. 461 (c))

(1) House changes

The House provision is discussed below with your committee's action.

(2) Change made by committee

Under present law a deduction for the payment of local property taxes accrues upon the date when the amount and liability for the tax become fixed. In many jurisdictions the amount and liability for a property tax for the calendar year 1955 would be fixed on a date late in 1954 and, under court decisions, is deductible for accrual-basis taxpayers only at that time.

The House bill provides that an accrual-basis taxpayer must in the future accrue a real property tax ratably over the period for which the property tax is imposed.

Special rules were provided by the House to cover the transitional problems which might arise as a result of the change. These rules would create a gap in property tax deductions and would artificially inflate income in the year of transition for many taxpayers who had deducted 1954 taxes in an earlier year.

Your committee's bill, therefore, provides that real property taxes related to a definite period of time may, at the election of the taxpayer, be accrued ratably over that period. Making the provisions elective will permit those taxpayers whose income would otherwise be distorted in the transition year to continue consistently the method under which their real property taxes have been accrued in the past. The transitional rules will apply only in those cases in which an election is made under this subsection.

G. 52- or 53-Week Year Accounting Periods (sec. 441)

(1) House changes accepted by committee

Under present law the accounting period used by a taxpayer in computing taxable income must end on the last day of a calendar month. Taxpayers in certain industries (e. g., retail sales, meat-packing, radio and television) for business reasons close their annual accounting period on a particular day of the week rather than on the last day of the month. The books of these taxpayers are closed on whatever date a particular day of the week occurs for the last time in a calendar month (or falls nearest to the end of a calendar month). As a result their annual accounting periods consist of 52 weeks (364 days) in 5 out of 6 years, and 53 weeks in the sixth year.

The House and your committee's bill enlarge the term "fiscal year" to include this 52- or 53-week period. This will make it possible for taxpayers who use such a period for business purposes to elect to use the same period in the computation of income for tax purposes.

Special rules are provided for effective dates and for the transitional problems which may arise in the year of change.

(*2*) *Changes made by committee*

The House bill restricted the use of the 52- or 53-week fiscal year to corporations. Your committee's bill provides that this fiscal year may be elected by any taxpayer who uses such an accounting period for business purposes. Other technical changes have been made by your committee.

II. Revenue Effect

It is estimated that the changes made by the House and your committee relating to accounting periods and principles will decrease revenues by $47 million in the fiscal year 1955.

XVI. Tax-Exempt Organizations

A. Employee Trusts

Provisions relating to the application of the rules governing tax-exempt organizations to qualified employee trusts are discussed under the section of this report relating to pension, stock bonus, and profit-sharing plans (see XIII-H).

B. Types of Exempt Organizations (sec. 501)

(*1*) *House changes accepted by committee*

The House bill did not add any types of organizations to the group exempt from Federal tax.

(*2*) *Changes made by committee*

Your committee has added to the group of exempt organizations corporations organized and operated exclusively for purposes of testing for public safety, no part of the earnings of which inures to the benefit of a private shareholder or individual.

C. Denial of Exemptions (sec. 504)

(*1*) *House changes accepted by committee*

The House bill did not make any changes in the nature of the provisions which deny tax-exemption to certain of the organizations listed in section 501 if they engaged in certain prohibited transactions.

(*2*) *Changes made by committee*

In this area one change of a clarifying nature was added by your committee which is intended to make clear the application of the prohibition against unreasonable accumulations of a trust in two types of situations. The section will not be applied at all to a testamentary trust established before January 1, 1951. In the case of a trust created by the will of a decedent dying after January 1, 1951, if the terms of the trust require an accumulation of income, the rule prohibiting accumulations which are unreasonable in amount or duration will be applied only during a taxable year beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

D. Business Leases (sec. 514)

(1) House changes accepted by your committee

Under present law educational, charitable, and certain other organizations are subject to tax on their rental income derived from leases for more than 5 years, to the extent of their outstanding indebtedness which was incurred to acquire or improve the leased property. The House bill subjects rental income to tax where borrowed funds are used to acquire or improve property which is leased for a time of less than 5 years but where the same business tenant occupies the property for more than 5 years. The tax is to become applicable only in the sixth year in which such tenant occupies the property. As in the case of leases for more than 5 years the tax is to apply only to the extent outstanding borrowed funds were used to acquire or improve the property. The House bill makes an exception to the unrelated business income provisions where a tax-exempt organization borrows funds to purchase property and such property is leased to several tenants provided that the tenants occupying 50 percent of the property have leases for less than 5 years.

(2) Changes made by committee

Your committee has retained these features of the House bill, and to make the exception effective it is provided that where tenants have the custom of making 5-year leases a new lease may be signed during the last half of the term of the old lease without the two terms being tacked on and treated as a lease longer than 5 years.

XVII. Accumulated Earnings Tax

Section 102 of existing law imposes a special tax on any corporation formed or availed of for the purpose of avoiding the surtax on shareholders by permitting earnings or profits to accumulate in the corporation. The statute further provides that if earnings and profits are permitted to accumulate beyond the reasonable needs of the business, this fact will be considered determinative of the purpose to avoid tax unless the corporation proves otherwise by the clear preponderance of the evidence.

Numerous complaints have been received that this provision is prejudicial to small business, that it has been applied in an arbitrary manner in many cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty tax is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes.

The House and your committee believe it is necessary to retain the penalty tax on unreasonable accumulations as a safeguard against tax avoidance. However, several amendments have been adopted to minimize the threat to corporations accumulating funds for legitimate business purposes and to restrict the application of the provision in the case of small companies.

A. Corporations Subject to Tax (sec. 532)

(1) House changes

The House provision which was rejected by your committee is discussed below.

(2) Changes made by committee

Under present law the section 102 tax is theoretically applicable to publicly held as well as closely held companies. As a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group.

The House bill provided a specific statutory exception for any corporation which has more than 1,500 shareholders and no more than 10 percent of the stock of which is held by any individual (including the members of his family). The corporation must demonstrate its right to the exception by showing that it meets the stock ownership requirement.

Testimony before your committee has indicated that it would be very difficult for many corporations which are generally recognized to be publicly held to establish from its records that not more than 10 percent of its stock is held by an individual and members of his family. Yet if publicly held corporations are to be exempted from this tax it is recognized that a requirement of this type is needed. In view of this and the fact that this tax is not now in practice applied to publicly held corporations, your committee believed it was desirable to remove the exemption provided for such corporations by the House bill.

B. Reasonable Needs of the Business (sec. 533 of House Bill and sec. 537 of Committee Bill)

(1) House changes accepted by committee

One of the principal reasons for confusion as to application of the section 102 tax has been the lack of adequate standards as to what constitutes the reasonable needs of the business. Some of the standards informally employed in the past, such as the distribution of 70 percent of earnings, have been erroneous or irrelevant. More often, in the absence of adequate guidance, revenue agents in examining cases have applied their individual concepts as to business needs.

As a result some improper criteria developed which have led to criticism of the tax on unreasonable accumulations. One such principle is the so-called immediacy test, under which there must be an immediate need for the funds in order to justify the retention of earnings. In some cases section 102 was applied even though the corporation had definite plans for expansion and the bona fides of the expansion program were not in question.

In order to eliminate the immediacy test, both the House and your committee have expressly provided in the statute that the reasonable needs of the business shall include the "reasonably anticipated" needs of the business. It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

The criticism has also been made that, in determining the reasonable needs of the business, consideration has been frequently given to events occurring after the close of the taxable year. Your committee agrees with the House that only the facts as of the close of the taxable year should be taken into account in determining whether an accumulation is reasonable. If the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year. However, subsequent events may be considered to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated.

Another subject of controversy in the administration of section 102 has been the use of retained earnings for the purpose of acquiring another business enterprise. Under existing interpretations, retained earnings may be invested in a business enterprise operated directly by the taxpayer, but doubt exists as to the operation of such a business through a subsidiary corporation controlled by the taxpayer. Your committee again agrees with the House that where the taxpayer has 80 percent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of such other corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, a factual determination should be made as to whether the funds are employed in a business operated by the taxpayer. However, the operation, through stock ownership of a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business, should not provide a basis for the exclusion of the funds from possible application of the accumulated earnings tax.

(2) Changes made by committee

Your committee has revised the draft of the House provision to indicate in section 537 that the reasonable needs of the business include the reasonably anticipated needs of the business instead of stating this in a parenthetical phrase in section 533. This is necessary to make it clear that the reasonable needs of the business, wherever it appears in connection with this tax, includes reasonably anticipated needs.

C. Burden of Proof (sec. 534)

(1) House changes accepted by committee

At the present time if the Commissioner of Internal Revenue proposes a deficiency on the ground that the taxpayer has accumulated earnings and profits in excess of the reasonable needs of the business, the taxpayer has the burden of proof as to the reasonableness of the accumulation. Moreover, if earnings and profits are accumulated in excess of the reasonable needs of the business, the accumulation is deemed to be for the purposes of tax avoidance unless the taxpayer proves otherwise by the clear preponderance of the evidence.

Your committee agrees with the House that this imposition of the burden of proof on the taxpayer has had several undesirable consequences. The poor record of the Government in the litigated cases in this area indicates that deficiencies have been asserted in many cases which were not adequately screened or analyzed. At the same time taxpayers were put to substantial expense and effort in proving that the accumulation was for the reasonable needs of the business. Moreover, the complaints of taxpayers that the tax is used as a threat by revenue agents to induce settlement on other issues appear to have a connection with the burden of proof which the taxpayer is required to assume. It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules.

Under the House and your committee's bill, the taxpayer may, upon receipt of notice of a proposed deficiency with respect to the accumulated earnings tax, file a statement of the grounds (together with sufficient facts to indicate the basis for the statement) on which the taxpayer relies to establish the reasonableness of the accumulation. If the taxpayer submits such a statement within the proper time, the burden of proof will be upon the Government as to whether the accumulation is in excess of the reasonable needs of the business. If the taxpayer does not file such a statement, it must bear the burden of proof as under existing law. In addition, if the taxpayer presents grounds in its statement which are not supported by the facts in the statement, the burden of proof with respect to these grounds must be borne by the taxpayer. If the Secretary or his delegate fails to give the taxpayer notification prior to the issuance of a notice of deficiency, then the Government must bear the burden of proof even though the taxpayer has filed no statement.

(2) Changes made by committee

Apart from changes made to conform this section with changes made in other sections your committee made only one substantive change in the House provision. The House provision requires that with the statement submitted by the taxpayer to shift the burden of proof there must also be submitted "facts sufficient to apprise the Secretary or his delegate of the basis thereof." Your committee believed this requirement was somewhat too rigid and has substituted "facts sufficient to show the basis thereof."

D. Computation of Accumulated Taxable Income Before Credit (sec. 535 (a) and (b))

(1) House changes accepted by committee

The House and your committee have revised and simplified the provisions relating to computation of the accumulated earnings tax. The foreign tax credit is to be allowed in determining the amount subject to the accumulated earnings tax. The corporation also is to be given credit, in computing the accumulated earnings tax, for dividends paid not later than the 15th day of the third month following the close of the taxable year. The latter amendment will aid corporations which make distribution shortly after the close of the taxable year on the basis of their financial position at the end of the year.

(2) Changes made by committee

Your committee made only technical changes in the first 2 subsections of section 535. It provided that the alternate capital gains tax is to be deducted as a tax rather than deducted as a part of the long-term capital gains tax.

E. Accumulated Earnings Credit (sec. 535 (c))

(1) House changes accepted by committee

Under present law small corporations are frequently unable to accumulate funds needed for expansion because of the threat of section 102. An analysis of section 102 deficiencies in recent years shows that a large percentage of the total number of deficiencies assessed and collected involved relatively small corporations. A large percentage of the taxpayers in this group paid the proposed section 102 tax without contest. The record suggests that the difficulties of proof and the cost of litigation frequently prove to be insurmountable obstacles to the smaller companies.

While the change in the burden of proof and clarification of criteria for application of the penalty tax will be of benefit to the small companies, it also appears desirable to provide a minimum amount which will not be subject to the accumulated earnings tax. Under the House bill a minimum accumulated earnings credit of $30,000 is provided. As is indicated below, your committee increased the minimum and also made other changes of considerable significance.

(*2*) *Changes made by committee*

Your committee has substantially revised the accumulated earnings credit provided by the House bill. It has provided a credit for the profits of the taxable year which are retained for the reasonable needs of the business and provided that in no case is this credit to be less than the amount by which $60,000 exceeds the accumulated profits of the corporation as of the end of the prior year. This in effect provides two changes in present law. In the future this tax will apply only to the amount unreasonably accumulated. Moreover, in no case will the tax be imposed on any corporation which has not accumulated earnings to the extent of $60,000. However, earnings may, of course, be accumulated in excess of $60,000 where the accumulation is for the reasonable needs of the business.

Your committee has provided that this tax is to be imposed only on the amount unreasonably accumulated because it sees no justification for imposing a penalty tax on accumulated earnings to the extent that the earnings were needed in the business. It is believed that it is this aspect of the tax which taxpayers generally find particularly alarming, because, while they may be confident that they can justify the accumulation of most of their earnings, they may feel less certain about a minor portion of their accumulations and fear that this will subject their entire accumulated earnings to tax.

The committee approved of the principle adopted by the House of providing a minimum accumulation for small businesses which in any case is free of this penalty tax but believed the $30,000 provided by the House was too small. For that reason it increased this minimum figure to $60,000.

It is estimated that the changes made by the House and your Committee in the accumulated earnings tax will decrease revenues in the fiscal year 1955 by $10 million.

XVIII. Personal Holding Companies

Both the House and your committee have retained the provisions of present law which impose a special tax on the undistributed income of personal holding companies. Several amendments have been made, however, to relieve inequities and to provide for more effective administration of these provisions.

A. Definition of Personal Holding Company (sec. 542)

(*1*) *House changes accepted by committee*

Under existing law a corporation first becomes subject to the personal holding company provisions only if it meets two tests: 80 percent or more of its gross income is personal holding company income as defined in the statute, and 50 percent or more of its stock is owned by five or fewer individuals (including members of their families). If in any 1 year the corporation meets the 80 percent income test, then the percentage test is 70 percent for each of the next 3 years. Your committee agrees with the House that the applicable percentage for the income test should be the same in each year and accordingly has accepted the House provision eliminating the 70 percent test. The single 80 percent income test will provide for more uniform treatment of taxpayers and will avoid the entrapment of taxpayers which may occur under present law.

The stock ownership requirements have been retained in substantially their present form. It has been suggested, however, that the purpose of these provisions may be negated where stock is owned by a tax-exempt organization or charitable trust. To prevent this form of avoidance, the House and your committee's bill provide that an exempt organization or charitable trust is to be counted as an individual in determining whether 50 percent or more of the stock is owned by five or less individuals.

The application of the personal holding company provisions to corporations filing a consolidated return has produced uncertainty under existing law when the common parent corporation receives dividend income from members of the group. In this situation it would appear that the group should be considered as a single corporation to determine whether the personal holding company income test is met. Accordingly, the provisions which have previously been applicable to affiliated groups of railroad corporations are extended to other affiliated groups. The qualifications for the group, which are different, however, under the House and your committee's bill, are discussed below.

(2) *Changes made by committee*

The House bill provides that a consolidated return may be filed by a group (other than a group of railroads) for purposes of the personal holding company tax if (1) the common parent derives 80 percent or more of its income from the affiliated group for the 3 preceding taxable years, (2) no member of the group would be a personal holding company if its income derived from the group is disregarded, and (3) no member of the group is a corporation exempt from the personal holding company provisions.

Your committee sees no reason why, in determining whether the personal holding company tax applies, a parent corporation which derives more than 20 percent of its income from its own operations should be deprived of the privilege of having its income consolidated with that of its subsidiaries. As a result your committee has stricken the first requirement provided by the House bill.

With respect to the second requirement, the attention of your committee has been called to the fact that where a corporation receives almost all of its income from subsidiaries, other income, although incidental, may be of the investment type and, therefore, this requirement of the House bill may deny it the right to file a consolidated return for purposes of applying the gross income requirement. Therefore, your committee has provided that income from outside the consolidated group is to be tested under this second House requirement only if it constitutes 10 percent or more of the company's gross income.

In addition, your committee has provided that dividends received by the common parent corporation from a corporation in which it owns more than 50 percent of its stock shall not be taken into account in applying the 10 percent test.

B. Personal Holding Company Income (sec. 543)

(1) House changes accepted by committee

The definition of personal holding company income has been amended by the House and your committee in two respects. Under present law cases of hardship frequently arise when a corporation rents property to its principal stockholders. Such rental income is treated as personal holding company income and the corporation may be subject to the penalty tax. This provision was originally inserted in the law with respect to incorporated yachts and residence but has been applied in the case of many legitimate business enterprises. The House and your committee have 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. Your committee has made a clarifying amendment, which is described below, to the House provision.

The second amendment to the definition of personal holding company made by the House and your committee makes it clear that gains from the sale of securities or commodities are not to be considered as gross income to the extent of the losses on such sales. Thus gross income and personal holding company income will reflect only the net gains from such transactions.

(2) Changes made by committee

Your committee has amended the House bill to make clear that in determining whether the corporation has more than 10 percent of its income from personal holding company sources, rental income from persons other than shareholders is not to be considered as personal holding company income. Accordingly, the exception in the House bill will be clearly applicable, for example, in the case of property which is rented both to shareholders and to persons who are not shareholders in the corporation.

A second amendment by your committee to the House bill excludes from the definition of personal holding company income interest earned on special reserve funds established under the Merchant Marine Act, 1936. Such interest is required to be retained in the reserve funds under the Merchant Marine Act for investment in shipping and should not be treated as personal holding company income.

C. Undistributed Personal Holding Company Income (sec. 545)

(1) House changes accepted by committee

In the computation of undistributed income subject to the personal holding company tax, the deduction for taxes has been clarified by the House and your committee to provide that taxes are to be deducted when accrued. Under existing law there has been considerable confusion as to whether taxes may be deducted in the year paid or in the year accrued. Both versions of the bill permit taxpayers who have been deducting taxes when paid to continue to do so but such taxpayers may, if they so desire, make an irrevocable election at any time to change to the accrual method.

The deduction allowed for taxes in computing amounts subject to the personal holding company tax has been extended to include foreign taxes claimed as a credit for income tax purposes.

Other amendments made by the House and your committee to the personal holding company provisions include technical revision of the 1 year net operating loss carryforward allowed to personal holding companies, and limitation of the provision of present law which excludes amounts subject to a lien from the personal holding company tax. The lien provision has been amended to provide that any income excluded under this provision is to be included in the income of the corporation for the year in which the lien is released. Dividends attributable to such an inclusion will be taxable to the shareholders either in the year of dividend payment or, at the election of the taxpayer, ratably over the period of the lien.

(2) Changes made by committee

The committee made only technical changes in this section. These include the restoration of the deduction for the capital loss carryover provision for the deduction of any alternative tax paid as a tax rather than as a part of the capital gain deduction, and minor changes in the charitable contribution deduction.

D. Deduction for Deficiency Dividends (sec. 547)

(1) House changes accepted by committee

The deficiency dividend provision, which enables a corporation to eliminate a prior personal holding company tax by making a special distribution of dividends, has been made generally applicable except in the case of fraud for willful failure to file an income tax return. The technical requirements applicable to deficiency dividends have been simplified in both versions of the bill in order to encourage such distributions. The benefits of the provision may be obtained by an informal agreement signed by the taxpayer and the Commissioner's representative in lieu of the cumbersome closing agreement procedure required at the present time.

(2) Changes made by committee

None.

E. Consent Dividends (sec. 565)

(1) House changes accepted by committee

The consent dividend provisions of existing law were enacted in connection with the undistributed profits tax in the 1930's to enable corporations to comply with dividend distribution requirements without the necessity of an actual payment of dividends. Since the expiration of the undistributed profits tax, the consent dividend provisions have been used only by personal holding companies. The House report indicated that in view of the limited use of these provisions and the liberalization of the deficiency dividend procedure, it had decided to eliminate these complicated provisions from the law.

(2) Changes made by committee

Your committee has restored the consent dividends provisions. Although these provisions are not frequently employed, they may be vital to a corporation which is required to distribute its earnings under the tax laws but is prevented from distributing cash because of loan restrictions, insufficiency of liquid resources, or for other reasons. Consent dividends may also be used where the shareholders discover after the close of the taxable year of the corporation that distributions during the taxable year have been inadequate. Under such circumstances the shareholders may, by the use of consents, agree to treat certain amounts as distributed during the taxable year. Your committee sees no reason why the corporation should not be entitled to credit for the distribution if the shareholders agree to include the amount in their income as a dividend.

However, your committee recognizes the validity of complaints directed to the complexity of the consent dividend provisions of the present law and has substantially redrafted these provisions in the interest of simplicity.

F. Integration of Income and Personal Holding Company Tax (sec. 6501 (f))

(1) House changes accepted by committee

Under both the House and your committee's bill, the personal holding tax has been integrated with the income tax so that a single return will serve the purposes of both taxes. It is anticipated that the Internal Revenue Service will provide a separate schedule to be filed by companies subject to this tax.

The integration of the taxes will eliminate the problem that arises under present law when a corporation subject to the tax fails, because of negligence or poor advice, to file a personal holding tax return. In such cases, the period of limitation on assessment of this tax remains open indefinitely, and the corporation may be barred from making a deficiency dividend distribution unless it can demonstrate that the failure to file a return was due to reasonable cause. Under both versions of the bill, the filing of an income-tax return will begin the running of the statute of limitations for both taxes. However, the period of limitation for assessment is extended to 6 years with respect to the personal holding company tax if the corporation fails to furnish information as to its stock ownership and items of personal holding company income.

(2) Ch mges made by committee

None.

XIX. Worthless Stock in Affiliated Banks (sec. 582)

(1) House changes accepted by committee

Under present law, losses on completely worthless stock or securities owned in an affiliated corporation are allowed as an ordinary loss if 90 percent of the aggregate gross income of the affiliated company for all taxable years was derived from sources other than investment income. In the past banks have not qualified for this tax treatment because most of their income is derived from investment sources.

Both versions of the bill remove this restriction in the case of banks by treating stock held in an affiliated bank as a noncapital asset. This provision places banks on a parity with other business corporations. Although the principal qualification of other types of business affiliates entitled to such tax treatment is noninvestment income, this rule was adopted to limit the tax benefits to companies whose affiliates were engaged in the same general type of business as the parent, rather than those used as a dumping ground for undesirable investments. Since loans and investments are the stock in trade of banks, it appears discriminatory not to allow banks a similar opportunity to take an ordinary loss on worthless stock in an affiliated company.

(2) Changes made by committee

None.

XX. Natural Resources

A. Rates of Percentage Depletion (sec. 613 (b))

(1) House changes accepted by committee

Under present law taxpayers owning economic interests in specified types of mineral deposits are allowed percentage depletion deductions whenever these exceed depletion based on capital costs. Such depletion is computed as the lesser of (a) a statutory percentage of gross income from mineral property or (b) 50 percent of the net income from the property before depletion. On mines of minerals not accorded percentage depletion, discovery depletion may be deducted as an alternative to cost depletion if discovery value materially exceeds investment costs.

Under the House and your committee's bill there are a few increases, but no reductions, in the rates of percentage depletion allowed by present law and regulations. The 2 versions of the bill have continued the present rates of percentage depletion of 27½ percent for oil and gas and 23 percent for sulfur. Under the new provisions, depletion allowances, other than those for oil, gas, and sulfur, are divided into two groups: Specific items depletable at 15, 10, and 5 percent and another general class for all other minerals.

The specific 15 percent group includes: Metal mines, rock asphalt, vermiculite, and ball, china, and sagger clay. All of these items under present law are entitled to the 15 percent rate.

The specific 10 percent group contains: Asbestos, brucite, coal, lignite, perlite, and wollastonite. Under present law all of these items receive the 10 percent rate, although lignite has been covered only by an interpretation that it is a grade of coal.

The specific 5 percent category includes all the items presently listed at 5 percent except those given a higher rate, and in addition the 5 percent class is to include peat and mollusk shells (including clam shells and oyster shells).

Generally, the minerals in the above categories will receive the stated depletion allowance regardless of the way they are used. All other minerals not specifically listed are placed in a general class to receive percentage depletion at the rate of 15 percent, subject to the limitation that if they are used for certain purposes for which crushed stone is commonly used, they are to be entitled to a percentage depletion rate of 5 percent. This use test is imposed to prevent discrimination in percentage depletion rates between materials which are used competitively for the same purposes. The general 15 percent category includes all the minerals not specified in the above groups which under present law receive in a few cases 10 percent, but, for the most part, 15 percent depletion. It also includes, for example, quartz sands or pebbles when sold for their silica content, and novaculite. In addition this general group also covers minerals for which percentage depletion is not presently available such as natural mineral pigments, olivine, and kyanite, but it does not include dirt, sod, or mosses, or minerals taken from the sea or air or from similar sources.

The classification of nonmetallic minerals into these broad all-inclusive groups makes it possible to eliminate the discovery value depletion provisions of present law.

(2) *Changes made by committee*

Your committee's bill makes some specific changes and additions. The effect is to increase the allowable rates in some instances but to make no reductions as compared either to present law or the House bill.

Under your committee's bill uranium would receive the 23 percent depletion rate instead of being included with other metal mines in the specific 15 percent group.

A new 23 percent group is established for the following strategic and critical minerals if they are produced from deposits within the United States: Anorthosite (to the extent alumina and aluminum compounds are extracted from it), antimony, asbestos, bauxite, beryl, bismuth, cadmium, celestite, chromite, cobalt, columbium, corundum, fluor spar, graphite, ilmenite, kyanite, lead, lithium, manganese, mercury, mica, nickel, platinum and platinum group metals, quartz crystals (radio grade), rutile, block steatite talc, tantalum, thorium, tin, tungsten, vanadium, zinc, and zircon. When these minerals are produced from deposits outside the United States they will be entitled to percentage depletion according to the rate classification provided in the House bill, namely, the specific 15 percent group for metals, the specific 10 percent group for asbestos, and the general 15 percent group for other nonmetallics. In the case of those metal ores specifically listed in the 23 percent category, depletion will be determined in the same manner and with regard to the same ordinary treatment processes as provided under the category of "metal mines".

Bentonite, under your committee's bill, is placed in the specific 15 percent group instead of being included in the general class which is subject to the use test. Sodium chloride is moved from the specific 5 percent to the specific 10 percent group.

Your committee has also modified the treatment of various types of stone. This is done by placing stone in the general class of all other minerals when used, or sold for use as dimension or ornamental stone. Under the House bill minerals falling in the general class and used as dimension or ornamental stone, as well as for common road material, would be restricted to 5 percent depletion. Your committee's bill, in contrast to the House provision, does not name chemical grade limestone, metallurgical grade limestone and slate in the specific 15 percent class, nor granite and marble, in the specific 5 percent class. Under your committee's bill the 5 percent rate will be applicable to stone when used or sold for use by the mine owner or operator for purposes other than dimension stone and ornamental stone. The use test, which determines which minerals of the general class receive 5 instead of 15 percent depletion, is limited to use as riprap, ballast, road material, rubble, concrete aggregates or for similar purposes. Thus all types of stone which are used as dimension or ornamental stone will receive 15 percent depletion. But when any mineral in the general class is used for such purposes as ballast or road material it will receive the 5 percent rate which is the same as the rate specified for gravel and sand.

Although the general class of other minerals provided by the House bill is designed to cover all minerals now entitled to percentage depletion but not specifically mentioned in the bill, a number of complaints have been received by your committee that this proposed treatment is less clear than present law. For this reason, and without limiting the scope of the general class, your committee has included in it the names of the following minerals which are in the present law: Aplite, barite, bauxite, beryl, borax, calcium carbonates, refractory and fire clay, diatomaceous earth, dolomite, feldspar, flake graphite, fluorspar, fuller's earth, garnet, gilsonite, granite, lepidolite, magnesite, magnesium carbonates, marble, mica, phosphate rock, potash, quartzite, slate, spodumene, talc (including pyrophyllite), thenardite, tripoli, and trona. Soapstone, limestone, and stone used or sold for use by the mine owner or operator as dimension stone or ornamental stone were also listed in conformity with the amended treatment of stone.

It is estimated that changes made by your committee in the rates of percentage depletion will decrease revenues by $34 million in fiscal year 1955.

B. Definition of Income from Property (sec. 613 (c))

(1) House changes accepted by committee

Under present law and the House bill, the gross income rates referred to above are applied to "gross income from the property." This is defined as gross income from mining, and "mining" in turn is defined as the extraction of the minerals, the "ordinary treatment processes" normally applied to obtain commercially marketable mineral products, and certain transportation.

The House bill continues these definitions except in three respects. In the case of magnesite, burning is to be regarded as an ordinary "treatment process" and in the case of talc, fine pulverizing is to be regarded as such a process. The present definition of "sulfur processing" is specifically related to the Frasch process, so that the general rule for ordinary treatment processes is to be available for sulfur produced in other ways.

(2) Changes made by committee

The term "ordinary treatment processes" in the case of coal was extended by the Committee to include "dust allaying and treating to prevent freezing." The latter process is now allowed under regulations. Also in the case of phosphate rock, "sintering and nodulizing" are included as an ordinary treatment process.

C. Mine Tailings (sec. 613)

(1) House changes accepted by committee

Depletion allowances under present law are allowed with respect to mines and natural deposits. The House and your committee's bill extends percentage depletion at the appropriate rates to mine owners for minerals recovered from the residue that had accumulated from their mine. The provision does not apply in the case of a purchaser of such waste or residue or to a purchaser of rights thereto.

(2) Changes made by committee

Your committee bill makes it clear that, while percentage depletion on waste or residue is not allowed in the case of a direct sale, it is to be allowed in the case of a successor in interest in a tax-free exchange.

D. Definition of Mineral Property (sec. 614)

(1) House changes accepted by committee

Although depletion allowances are computed with respect to mineral properties, present law does not define a "property." In general administrative regulations state that each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land constitutes a property. From the standpoint of both taxpayers and administrators, however, this division of properties creates difficulties because, in some instances, it requires the preparation of multiple depletion schedules and computations where a single computation would serve the same purpose.

The House bill clarifies the situation with respect to depletable properties by adding a statutory definition of "the property." This provision adopts as the general rule the same definition relating to separate interests now established by regulations. In addition, however, the new provision permits a taxpayer to elect for purposes of percentage depletion to treat as one property an aggregation of his separate mineral interests which constitute all or part of an operating unit.

(2) Changes made by the committee

While the House bill permits an aggregation of mineral interests within an operating unit only for purposes of percentage depletion, your committee allows such an aggregation also for cost depletion. Where an aggregation is elected, the properties must also be aggregated in computing basis for gain or loss.

Your committee also permits an aggregation of interests in the case of owners of nonoperating interests, such as royalties, if these interests are in a single tract or contiguous tracts, and providing that the owners show the aggregation to be necessary to prevent exceptional hardship.

E. Exploration Expenses (sec. 615)

(1) House changes accepted by committee

The House bill made only technical changes in regard to exploration expenditures.

(2) Change made by committee

Under existing law and the House bill, a taxpayer may deduct in the current year expenditures for mine exploration not in excess of $75,000, or he may elect to defer any part of these expenditures and deduct them ratably as the ores or minerals are sold. The deduction or election is limited to any 4 years. Your committee has increased the annual limit on the amount of exploration expenditures which may be expensed or deferred from $75,000 to $100,000.

F. Gain or Loss in the Case of Timber, Coal, or Iron Ore (secs. 272, 631)

(1) House changes accepted by committee

Under present law a taxpayer who owns or has contract rights to cut timber may elect to treat the cutting of timber as a sale or exchange. Similarly, a taxpayer who owns timber or who receives coal royalties may treat his receipts from the disposition of timber and coal as capital gain. The House bill includes a provision identifying expenses in connection with the sales, or with receipts of royalties from leases, which are to be treated as an adjustment to the basis and an offset against capital gain and those which are properly applicable against ordinary income. The expenses which serve to reduce the amount of the capital gains are, under section 272, disallowed as deductions in computing ordinary taxable income.

In addition, the word "owner" in the case of certain sales of coal is defined in the House bill to mean any person who owns an economic interest in coal in place, including a sublessor.

(2) Changes made by committee

Your committee has rearranged the treatment provided by the House bill into two parts relating (1) to timber and (2) to coal, and this latter part is extended to iron ore from deposits in the United States. Thus royalty income of a lessor from a domestic iron ore property held for more than 6 months will be considered as gain or loss on the sale of the iron ore. In these cases percentage depletion will not be available.

The separate provision for capital gains treatment of timber eliminates the specific House requirement for allocation of expenses, and in effect continues the treatment of such expenses which is provided under present law and regulations. Conforming changes are made in section 272 by deleting all references to timber expenses.

A new provision is added stating that the date of disposal for timber is to be the date such timber is cut unless the timber is paid for prior to cutting. If the timber is paid for and then is cut at a later date, the taxpayer may elect to treat either the date the timber is cut or paid for as the date of disposal. Your committee also provides that an owner of timber is to include a sublessor for purposes of receiving capital gain treatment in the same manner as was provided in the House bill in the case of coal. In addition, the term "timber" in the committee bill will include "Christmas trees," i. e., evergreen trees which are more than 6 years old when severed from the roots and which are sold for ornamental purposes.

Since your committee was considering only the problem of taxing coal, timber, and iron ore in 1954 and future years, no inference should be drawn from your committee's action as to the meaning of present law.

It is estimated that the allowance of capital gains treatment in the case of iron ore will decrease revenues in the fiscal year 1955 by $10 million.

G. Capital Expenditures (sec. 263)

(1) House changes

The House bill made no change from present law in this area.

(2) Changes made by committee

Your committee has added an amendment to make it clear that the provisions of the bill do not affect the treatment now allowed by regulations relating to the deduction or capitalization of intangible drilling and development costs in the case of oil and gas.

XXI. Estates, Trusts, and Their Beneficiaries

Subchapter J of H. R. 8300 provides a logical arrangement of the provisions governing the income taxation of estates and trusts and their beneficiaries, and combines in one place the substantive rules relating thereto. Moreover, the House bill contains a number of substantive changes in the tax treatment of estates and trusts which are intended to eliminate uncertainties, plug loopholes, and cure inequities which exist under present law. Special types of trusts which are not governed by those provisions, such as employees' trusts and common trust funds, are treated elsewhere in the new bill.

A. *General Rules* (*subpart A, secs. 641–643*)

(*1*) *House changes accepted by committee*

Your committee's bill contains the basic principles of existing law under which estates and trusts are treated as separate taxable entities, but are generally regarded as conduits through which income passes to the beneficiary. The estate or trust is taxed in general in the same manner as an individual, but is allowed an additional deduction for income distributions to its beneficiaries.

The credits and deductions provided by section 642 are substantially the same as under present law with two exceptions:

(*a*) The deduction for a personal exemption was increased from $100 to $300 for certain trusts (the present $600 for estates remains unchanged) to eliminate the taxation of small amounts of capital gains realized by currently distributable trusts.

(*b*) An exclusion is allowed for the first $50 or $100 of dividend income and a tax credit equal to 5 percent or 10 percent of any remaining income, to aline the tax treatment of trusts and estates with the general-dividends-received provision.

The bill adopts the general principle that to the extent of the trust's current income all distributions are deductible by the estate or trust and taxable to the beneficiaries. This approach represents a basic departure from the general rule of the existing law that taxable distributions must be traced to the income of the estate or trust for the current year.

This approach, however, requires the use of a measure to impose an outside limit on the total distributions deductible by the estate or trust and taxable to the beneficiary. In general, the measure adopted by the bill for this purpose is taxable income, computed without regard to capital gains and losses unless these gains and losses are utilized in determining the income available for distribution.

In order to implement the conduit theory in a satisfactory manner, it is necessary to include in the measure items of income and deductions which are not reflected in taxable income. The bill adopts the concept of "distributable net income" as the measure and adjusts the amount of the distributions deductible by the estate or trust and taxable to the beneficiaries by eliminating not only capital gains and losses but items of income and expenses which do not enter into the computation of taxable income. Thus, the distributable net income of an estate or trust is defined as its taxable income for the current year, excluding capital gains and losses not distributed by the estate or trust, the portion of extraordinary dividends and taxable stock dividends allocated to principal (in the case of simple trusts described below), and the dividends-received exclusion, but including tax-exempt interest and foreign income of foreign trusts.

The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year. The simplicity of this general principle makes it possible to eliminate the so-called 65-day and the 12-month rules of existing law. Under the bill, with certain exceptions, amounts distributed in 1 year will not be considered to have been distributed in a preceding year, and the source of a distribution, whether made from the income of the current year or of a preceding year, is immaterial in determining the taxability of the distribution in the hands of the beneficiary. Furthermore, amounts not included in the gross income of the estate or trust will generally not be taxable to the beneficiaries.

(2) Changes made by committee

Your committee has made the following changes in sections 642 and 643:

(*a*) A rule for determining the time a beneficiary is deemed to have received dividends for purposes of the dividends received credit of section 34 and the dividends received exclusion of section 116 has been added to section 642 (a) (3).

(*b*) Subsection (h) of section 642 appeared in substance in the House bill as section 662 (d), relating to excess deductions on termination available to beneficiaries. Under this provision unused loss carryovers and deductions in excess of gross income in the year of termination of the estate or trust are made available to the remainderman to whom the property is distributed. Under existing law these unused carryovers and excess deductions are wasted when the estate or trust terminates.

(*c*) The definition of distributable net income contained in the House bill has been clarified by certain technical changes.

Also, other changes of a technical nature have been made with respect to these provisions.

It is estimated that the increase in the exemption from $100 to $300 for certain trusts will decrease revenues in the fiscal year 1955 by $3 million.

B. "Simple" Trusts (subpart B, secs. 651 and 652).

(1) House changes accepted by committee

A trust (but not an estate) may qualify under the committee's "simple trust" provisions if all of its income is required to be distributed currently and it makes no charitable distributions. If it makes occasional distributions out of principal it is disqualified only for the years in which the principal is distributed.

Qualifying trusts are allowed to deduct distributions made to the extent of their distributable net income and beneficiaries are required to include the distributions in their incomes for tax purposes only to the same extent.

The bill expressly provides that the character of the income to the beneficiaries is to be the same as it was in the hands of the trust (e. g., capital gains to the trust are capital gains to the beneficiaries) and a specific rule is provided to divide up the various types of income among the beneficiaries.

Essentially the treatment provided for simple trusts is the same as that provided by present law but for these trusts many complicated provisions, required for the more complex trusts, are separated and made inapplicable. Your committee believes that these provisions will materially simplify the law with respect to the large majority of trusts which will qualify under these rules.

(2) Changes made by committee

None.

C. "Complex" Trusts and Estates (subpart C, secs. 661-663)

(1) House changes accepted by committee

For all estates and trusts not qualifiying under the simple trust provision (including discretionary trusts, trusts with charitable beneficiaries, and trusts making current distributions but also making distributions of principal) deductions are—

(*a*) first allowed for distributions required to be made currently, and

(*b*) then, if any distributable net income remains, allowed for any other amounts distributed (other than gifts or bequests) but only to the extent of the remaining distributable net income.

In the case of these trusts or estates which may have paid out or set aside amounts for charitable purposes, their taxable income, and therefore their distributable net income, is already reduced by such amounts.

The beneficiaries of these trusts (or estates) are required to include in their income for tax purposes, distributions made to them out of income required to be distributed currently and then other distributions made to them to the extent of their proportionate share of the amount allowed as a deduction to the trust.

The bill specifically provides that the income to the beneficiaries, as in the case of the simple trusts, retains the same character it had in the hands of the trust, with each beneficiary considered as receiving his proportionate share of all types of the income distributed.

(2) Changes made by committee

Section 663 of the House bill has been completely revised. Subsection (a), relating to amounts which are excluded from the application of sections 661 and 662, has been revised in order to clarify and make more certain which distributions are to be excluded as gifts or bequests. In general, a gift or bequest which must be paid either in a lump sum or in not more than three installments is excluded.

Subsection (b) of section 663 is entirely new. It was brought to the attention of your committee that in certain instances the terms of the trust instrument of existing trusts preclude distributions until the close of the taxable year and thus distributions are made in reliance on the 65-day rule of existing law. Your committee has adopted subsection (b) to prevent undue hardships and inequities in this connection with respect to these trusts which were in existence prior to January 1, 1954, by giving the fiduciary a right to irrevocably elect to apply the 65-day rule.

Subsection (c) of section 663 is entirely new. Under the theory adopted in the bill, as under present law, it is possible that one beneficiary may be subjected to tax by reason of trust income which is reserved for and only available to another beneficiary. Under this provision if it is determined under pertinent regulations prescribed by the Secretary that a trust having two or more beneficiaries is to be administered in well-defined separate and independent shares, such separate shares are to be treated as separate trusts for the purpose of determining the amount of distributable net income available for allocation to the beneficiaries. It is believed that this provision will remove inequitable results that may result under present law in those instances in which the grantor clearly intends each beneficiary to have a definite share.

D. Five-Year Throwback Rule (subpart D, secs. 665–668)

(1) House changes accepted by committee

In spite of the "65-day and 12-month rules" of existing law, it is still possible to shift the tax burden in part from a beneficiary to a trust. For example, if the distribution of trust income for one year is deferred to a date more than 65 days after the beginning of the following year, and the trust income for the following year is distributed within the first 65 days after the end of that year, the beneficiary is taxable to the extent of the trust income for the second year only, even though he received all the income for both years. The purpose of the "throwback rule" is to close this tax-avoidance loophole in the existing law.

To meet this and similar situations, your committee's bill provides that distributions by a trust in excess of its distributable net income for the current taxable year will be "thrown back" to each of the 5 preceding years in inverse order and will be taxed to the beneficiaries to the extent that the distributable net income of those years was not, in fact, distributed.

To prevent double taxation, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess so thrown back. However, the beneficiaries are deemed to have received their share of the tax paid by the trust on this excess. In effect, the beneficiaries, except for the fact that they report the income currently, are placed in the same position as if the trust made the distribution at the time it received the income. This throwback provision applies only to accumulations of income in taxable years beginning after December 31, 1953. It does not apply to estates or generally to simple trusts.

(2) Changes made by committee

Under the House bill distributions exceeding distributable net income by less than $2,000, distributions representing accumulations during the minority (or before the birth) of the beneficiary, and distributions for the maintenance, support, or education of a beneficiary were specifically excluded from the application of the 5-year throwback rule. Your committee believes that the exception for "maintenance, support, or education of the beneficiary" is too broad and, in order to prevent employment of this provision as an escape from the application of the rule, has amended this section so that the exception will apply only to amounts distributed to meet the "emergency needs" of a beneficiary.

In addition, your committee has inserted two new exceptions. Section 665 (b) (3) excepts from the application of the throwback rule certain distributions required to be made under the terms of trusts in existence prior to January 1, 1954, under which accumulated income is required to be distributed at specified ages of at least 4-year intervals after the beneficiary reaches the age of 21 years.

Paragraph (4) of section 665 (b) excludes amounts distributed to a beneficiary as a final distribution of the trust where such distribution does not occur within the first 10 years following the last transfer of property to the trust. It is believed that these two additional exceptions to the throwback rule cover those situations in which legitimate estate planning and management, rather than tax avoidance, motivate the distributions.

Your committee has also made certain technical amendments with respect to other provisions in this subpart.

E. Applicability of Provisions (sec. 683).

The provisions of this subchapter are applicable only to taxable years beginning after December 31, 1953, and ending after the date of enactment of this bill. Under the House bill the 65-day rule of present law was made inapplicable to distributions made within the first 65 days of any taxable year commencing after January 1, 1954. It has come to the attention of your committee that numerous hardships will result from such a provision since many taxpayers have conducted their affairs in reliance upon the 65-day rule of present law. Accordingly, in order to avoid such hardships and inequities your committee has amended section 683 to provide for the application of the 65-day rule of present law to distributions made within the first 65-days of the first taxable year subject to the new provisions of this bill.

F. "Clifford" Type Trusts (secs. 671–678)

(1) House changes accepted by committee

The House bill provides rules to determine when a trust's income is to be taxed to the grantor because of the grantor's substantial dominion and control of the trust property or income.

Existing law contains a statutory provision dealing with trusts in which the grantor retains a power of revocation and also a provision dealing with trusts whose income is accumulated or used for the benefit of the grantor. In addition, regulations (commonly known as the Clifford Regulations) provide a series of rules to determine when trust income is to be taxed to the grantor because of: a reversionary interest within a specified period; powers to control the beneficial enjoyment; or certain broad administrative powers. These regulations are based on the assumption that the grantor may be taxed under the general definition of income. If the grantor retains such elements of control, he is deemed to be the owner even though the trust is irrevocable.

Your committee believes that the rules for determining when the grantor should be treated as the substantial owner of the trust should be set forth in the statute rather than left to regulations. Thus, the bill includes specific provisions to this effect in the estate and trust chapter. These provisions generally adopt the approach of the regulations (and the two provisions of existing law) but with important modifications.

Under the regulations, trust income is taxed to the grantor where he can take back the principal or income within 15 years, if he (or his wife) as trustee has certain administrative powers over the trust property. If he does not possess these powers, the trust income will be taxed to him if he can recapture the principal or income within 10 years. Under your committee's bill the grantor is not to be taxed by reason of a reversionary interest in an irrevocable trust unless the reversion may occur within 10 years. If the beneficiary is a designated school, hospital, or church, the grantor is to be taxable because of a reversionary interest only if the reversion will occur within less than 2 years.

The bill also departs from the regulations in the treatment of a power to apportion income or principal among different beneficiaries. Under the regulations, the grantor will be taxed on the trust income if certain related or subordinate trustees hold such a power. Under the bill, the grantor will not be taxed if he can establish that the related or subordinate trustee is not acting in accordance with the grantor's wishes. However, the grantor must overcome a presumption that the related or subordinate party is subservient to him.

A person other than the grantor may be treated as the substantial owner of a trust if he has an unrestricted power to take the trust principal or income, or if he has modified this power (by release or otherwise) but has retained powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable because of such a power. Similar rules are contained in the regulations under existing law (commonly known as the Mallinckrodt Regulations). The bill, however, makes a specific exception to the effect that a power to apply the income for support of dependents is not to result in the trust income being taxable to such other person unless the income is actually applied for the support of dependents.

(*2*) *Changes made by committee*

Your committee has generally adopted the provisions of the House bill but has made certain technical changes, principally to insure that the provisions of the bill are more closely aligned with the provisions presently contained in existing regulations.

G. Revenue Effect

Only the increase in exemptions from $100 to $300 is expected to affect revenues to an appreciable extent. It is estimated that this will decrease revenues in the fiscal year 1955 by $3 million.

XXII. INCOME IN RESPECT OF DECEDENTS (SECS. 691, 692)

(*1*) *House changes accepted by committee*

Under existing law income in respect of a decedent which is received after his death by his estate or other beneficiaries is taxed to the recipients rather than being treated as accruing to the decedent in a lump sum immediately prior to his death. The recipients are allowed an offsetting deduction for any estate tax attributable to the inclusion of this right to income in the decedent's gross estate, but do not acquire a new basis for this property at the date of the decedent's death.

The above treatment, under existing law is limited to the first decedent. Thus, a widow of an insurance agent who receives the right to commissions on future insurance premiums includes these commissions in her income when received and is allowed a deduction for any estate tax attributable to the commissions. However, if the widow dies and the right to any remaining future commissions is left in her estate, existing law requires the lumping of these rights to income in the widow's last income tax return rather than treating it as income in respect of a decedent. Your committee's bill gives relief in this situation by providing that a right to income received from a decedent, or a prior decedent, is to be includible in the income of the recipient with an offsetting deduction for any estate tax attributable to such property.

Under existing law, it is not clear whether income in respect of a decedent which is received by an estate or trust will be treated as such in the hands of the beneficiary if distributed by the estate or trust. Your committee's bill provides that if the estate or trust makes a distribution of income in respect of the decedent, the deduction for the estate tax is to be given to the recipient beneficiary, instead of the estate or trust.

Under existing law, gain on uncollected installment obligations, is treated as realized on the death of the decedent. An exception is provided to this rule, however, if a bond is filed which is conditioned on the subsequent reporting of the gain on the obligation by the person who acquires the obligation from the decedent. Your committee's bill eliminates the necessity of this bond requirement by providing that in all cases the uncollected installment obligations are to be treated as income in respect of the decedent. The recipient will therefore report the installment gain in the same manner as if it had been received by the decedent. Also the recipient will be entitled to a deduction for any estate tax attributable to inclusion in the decedent's estate of the right to the installment income.

The House and your committee's bill also extends the treatment provided for income in respect of a decedent to several forms of income not now eligible. This treatment is extended to that part of the value of a survivor's annuity included in the estate-tax base of the decedent annuitant which represents the interest accumulation for the survivor annuity since the annuity's purchase. This treatment is also extended to the value of unexercised "restricted stock options" included in the gross estate of the decedent employee and to payments to a deceased partner by a partnership which are includible in the income of the estate or beneficiary of the deceased partner. This treatment is provided for these new forms of income as a part of your committee's policy of providing that all property or property rights included in a decedent's gross estate for estate-tax purposes either receive a new basis at the date of his death or, if subsequently to be reported as income when that event occurs receive a deduction for the estate tax paid in the decedent's estate attributable to such property.

(2) *Changes made by committee*

Your committee deleted from section 72 a provision for an additional deduction to a survivor in a joint and survivor annuity based upon the estate tax attributable to a portion of the basis of the annuity for estate tax purposes. This provision was contained in subsection (j) of section 72. It was considered by your committee that the manner in which the deduction was provided in the House bill took into account mortality gains and losses that were already given adequate consideration in establishing the exclusion ratio. There is a problem of double taxation between the estate tax and the income tax of the survivor's share of a joint and survivor annuity, but it is best recognized, as a problem similar to taxation of income in respect of decedents.

Under section 72 in a joint and survivor annuity, an exclusion ratio will be determined which will indicate the average interest earnings over the combined lives of the two annuitants. The survivor will continue to use this exclusion ratio although somewhat less interest than this will be earned in the latter years while she is receiving an annuity and more interest than this will be earned in the early years while they are both receiving the joint annuity. The provisions contained in subparagraph (C) in both paragraphs (1) and (2) of subsection (c) of section 691 are designed to provide a deduction to the survivor based upon the estate tax attributable to a portion of the survivor annuity which represents the excess interest earned while the annuity was being received jointly. This is, in effect, income in respect of a decedent. This deduction will be spread ratably over the life expectancy of the survivor.

XXIII. Partners and Partnerships

The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory 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.

This confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.

Because of the vital need for clarification, the House and your committee have undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws. In establishing a broad pattern applicable to partnerships generally, the principal objectives have been simplicity, flexibility, and equity as between the partners.

In general, the proposed statutory treatment retains the existing scheme of regarding the partnership as merely an income-reporting, and not a taxable, entity. In addition, a statutory pattern has been established for contributions to a partnership, distributions by a partnership, transfers of partnership interests by sale or on the death of a partner, termination of partnership taxable years, transactions between a partner and the partnership, and the treatment of payments to a retiring partner or a deceased partner's estate or heir.

A. Determination of Tax Liability (secs. 701-708)

(1) House changes accepted by committee

(a) Income of partners.—Under the House and your committee's bill, as under present law, partners will be liable individually for income tax on their distributive shares of partnership income. The partnership will act as a mere conduit as to income and loss items, transferring such items directly to the individual partners.

The items required to be segregated will retain their original character in the hands of the partner as though they were realized directly by him from the same source from which realized by the partnership and in the same manner. After excluding the items required to be separately treated, the remaining income or loss, which corresponds to the ordinary income or loss of the partnership under present law, is attributed to the partners.

The computation of partnership income is generally on the same basis as existing law. The partnership is allowed the usual business deductions, but is denied the deductions peculiar to individuals.

Both versions of the bill provide that all elections with respect to income derived from a partnership (other than the election to claim a credit for foreign taxes) are to be made at the partnership level and not by the individual partners. This rule recognizes the partnership as an entity for purposes of income reporting. It avoids the confusion which would occur if each partner were to determine partnership income separately for his own purposes.

(*b*) *Distributive shares.*—The taxation of partnership income or other items directly to the partners requires a determination of each partner's share of such items. In general, such shares will be determined in accordance with the partnership agreement as under existing practice.

In the case of property contributed to a partnership, there has been considerable doubt, under present law, as to the partners' distributive shares of gain and loss upon the sale of such property and as to the allocation among the partners of depreciation on such property. This problem arises when the tax basis of the contributed property is greater or less than the value of such property at the time of contribution. Under the approach adopted by the House bill, the so-called entity rule, the allocation of gain or loss and of depreciation is to be in accordance with the distributive shares of the partners generally. Thus, if 1 of 2 equal partners contributes to a partnership property which is worth $100 but has a tax basis of $40, and the other partner contributes cash of $100 which is used to purchase property with a value of $100, the partners will share equally in the depreciation allowance, notwithstanding the low basis of the property contributed by the first partner. The sharing of gain or loss upon a sale or exchange of either property will also be identical as between the partners. However, upon the liquidation of the partnership the partners who have received too large depreciation deductions (or too small a gain) will receive relatively larger capital gains than will be true in the case of the other partners. This general treatment was adopted because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners.

Your committee has accepted as a general rule the "entity" rule provided by the House bill but, as is indicated in the discussion below, also permits the use of the so-called aggregate rule for contributed property.

(*c*) *Determination of basis of partner's interest.*—The House bill provides that the basis of a partner's interest in a partnership is to be his basis for any contributions he made to the partnership and the amount he paid for any purchased interest, subject to certain adjustments. This basis is to be increased by the partner's share of income received from the partnership, whether or not it was taxable to him. It also is to be decreased by any distributions of money or property made to the partner and by his share of the partnership losses and expenditures of the partnership which were not deductible for tax purposes and were not capital expenditures.

Although the present statutory provisions do not provide for the adjustments described above with respect to the basis of a partner's interest in a partnership, these adjustments are implicit in the present provisions and regulations. Your committee has in general adopted these House provisions but, as indicated below, has provided an alternative method for determining the basis of a partner's interest in certain cases.

(*d*) *Taxable years of partners and partnerships.*—Under existing law a partner treats his distributive share of partnership income as income to him at the close of the partnership taxable year. Such income is not reportable by the partner until he files his return for the taxable year in which such partnership year ends. Because of these rules it has been possible, generally by the selection of a fiscal year as partnership year, to postpone the realization of partnership income by as much as 11 months.

To prevent this practice, the House bill provides, in general, that a partnership may not, without the consent of the Secretary or his delegate, either adopt a fiscal year or change from a calendar year to a fiscal year. The same requirement is made applicable to partners shifting from a calendar year to a fiscal year basis. The House report suggests that the use of a fiscal year would be approved where valid business reasons for such an accounting period are shown.

As indicated below, your committee has revised considerably this provision of the House bill.

Under present law there has been the contention that the death of a partner closes the partnership year and the bunching of more than a year's income in the decedent's last year. Where the partnership and the partners are on different taxable years, this would have the effect of concentrating as much as 23 months' income in the final return of the deceased partner, that is, the income for the partnership year ending within his taxable year and the income for the taxable year closed by the partner's death. Both the House and your committee's bill make it clear that the partnership year does not close upon the death of the partner. The partnership year will run to its normal conclusion, and the decedent's share of the income for this year will be taxable to the estate. To the extent that the right to receive this income constitutes income in respect of a decedent, the estate is entitled to a deduction for estate tax attributable to the inclusion in the decedent's estate.

Both versions of the bill also provide that the taxable year of a partnership is not to close as a result of the admission of a new partner, the liquidation of a partner's interest by means of a distribution, or a sale or exchange of a partner's interest in the partnership. Thus, it will not be possible by any of these events in themselves to terminate the partnership taxable year and commence a new partnership year. However, the partnership year does close if there is a termination of the partnership. A termination is defined for this purpose as a discontinuance of the business activities carried on by the partnership, or the sale of an interest of more than 50 percent in partnership capital or profits to persons not members of the partnership. The partners may elect to ignore the termination if they wish to continue to the close of the normal partnership year.

While the partnership year does not close for the continuing partners when a partner severs his interest in the partnership, the partnership year does close with respect to such partner. When a partner merely reduces his interest in a partnership, there is no change in the partnership taxable year with respect to him, but the amount of his distributive share must be determined with regard to his ownership of varying interests during the year.

(e) *Transaction between partner and partnership.*—When a partner sells property to, or performs services for the partnership, the problem arises whether the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership (the "entity" approach). An alternative ("aggregate" approach) is to view the partner as dealing with himself to the extent of his own interest and as dealing with the partnership with respect to the balance of the transaction. The present code fails to cover the problem and judicial decisions on the subject go in both directions. Because of its simplicity of operation, the "entity" rule has been adopted by the House and your committee.

However, certain safeguards are included to prevent the sale of property between the partnership and a "controlling" partner for the purpose of recognizing losses or raising the basis of property. Under the rule provided by the House bill, a sale between the partnership and a partner will not be recognized if it involves a "controlling" partner, that is, a partner who owns 50 percent or more of a capital or income interest in the partnership. Where a sale involves a controlling partner, any money or property passing between the partner and the partnership under the House bill is treated as a distribution or a contribution, the basis of the property transferred remaining unchanged. Your committee while retaining the entity approach has, as is indicated below, adopted treatment more nearly like that provided in the case of similar transactions between a corporation and its shareholder.

The payment of a salary by the partnership to a partner for services again raises the problem as to whether the partnership is to be viewed as an entity or merely as an aggregate of the activities of the members. Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The House bill provides that payment of a fixed or guaranteed amount for services is to be treated as salary income to the recipient and allowed as a business deduction to the partnership. As indicated below, your committee makes slight changes in the case of these service payments and extends the rule to interest payments.

(2) *Changes made by committee*

In general your committee has retained the House provisions described above. It has, however, made a number of perfecting amendments and also the substantive changes, described below, which are intended primarily to make the House partnership provisions more flexible.

(*a*) *Aggregate rule for contributed property.*—As an alternative to the entity rule described above for determining the basis of property contributed to a partnership, your committee's bill provides that, if the partnership agreement so provides, the basis of contributed property may, in effect, be divided among the partners in a way which attributes precontribution appreciation or depreciation in value to the contributor. This is to be available for purposes of computing depreciation, depletion, and gain or loss upon sale but not in the case of distributions. Thus, in an equal partnership where one partner contributed cash of $100 to a partnership and the other contributed property with a basis of $40 but a current value of $100, the partners could agree that the partner contributing the cash would have all of the $40 basis for allocating depreciation and also allocating the gain or loss if the property is sold.

This rule is admittedly more complicated than the entity rule which is provided unless the partnership agreement provides otherwise. However, while the partnership remains in operation, this aggregate rule more equitably computes the taxable income of the partners. Since this is not a matter involving revenue considerations to the Government, and since partners are not compelled to use this rule, your committee believes that partners should be free to choose this more complicated rule for dividing basis of property if they desire the more accurate tax results it brings.

Your committee has also provided that in the case of undivided interests, such as joint tenancies, that basis of property is to be determined (except for distributions) in the same manner as if there were no partnership, unless the partnership agreement provides otherwise. This is designed primarily to avoid the shifting of rules for computing depreciation, depletion, and gain or loss when a joint tenancy or similar undivided interest is unintentionally handled in such a way as to constitute a partnership.

(*b*) *Alternative method of determining basis of partner's interest.*—Your committee has in general followed the House provision outlined above for determining adjustments to the basis of a partner's interest. It has made it clear, however, that these adjustments need only to be made when it is necessary to determine the basis of a partner's interest and need not be made annually. It is generally necessary to know the basis of a partner's interest only in the case of a transfer of an interest or in the case of unusual distributions to the partner. Your committee has also provided, however, that in lieu of the relatively detailed adjustments outlined in the House bill for determining the basis of a partner's interest, this basis may be determined by reference to the partner's proportionate share of the adjusted basis of partnership property. The cases in which this alternative, or variations of this alternative, may be available to a partner are left to regulations.

(*c*) *Changing or adopting new taxable years.*—Your committee is as concerned about the postponement of the reporting of partnership income by the partners as is the House. However, it also objects to the House provision which compels partners and partnerships to adopt calendar years unless permitted to do otherwise by the Secretary or his delegate. Without any standards in the statute, this leaves in too uncertain a status the types of cases which will be required to use a calendar year.

In lieu of this provision your committee has provided that partners and partnerships may change to or adopt any year they see fit so long as both the principal partners and partnership change to or adopt the same year. For this purpose a principal partner is one who has an interest of 5 percent or more in the partnership. Moreover, different taxable years may be adopted by the partnership and its principal partners if a business purpose is established to the satisfaction of the Secretary or his delegate for different years.

(*d*) *Transactions between partners and partnerships.*—Your committee believed that the House rule which treats gains from transactions between partners and partnerships as distributions or contributions was unduly harsh since there is little opportunity in this area to convert potential ordinary income into capital gains. Moreover, much more lenient treatment is already provided in the case of similar transactions between corporations and their stockholders.

In view of this your committee substituted for the House rules the present provisions applicable in the case of corporations. Thus, gains in such transactions will be recognized unless the partner involved has an interest of 80 percent or more. Where the interest is in excess of 80 percent, the gain is to be an ordinary gain. In the case of losses, the 50 percent rule is retained, as is provided for corporations. However, if the loss is in a transaction with a partner having an interest of more than 50 percent, the deduction for the loss is denied.

In the case of guaranteed salary payments your committee followed the House bill but made it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid and that this treatment is only provided for purposes of the reporting of the income by the partner and the deducting of the payments by the partnership. Your committee also extended this treatment to guaranteed interest payments on capital.

B. Contributions to a Partnership (secs. 721–723)

(1) House changes accepted by committee

Contributions to a partnership will have the same effect under the provisions adopted by the House and your committee as under present practice. No gain or loss is to be recognized either to the contributing partner or to the partnership. The property contributed to a partnership is to have the same basis to the partnership for purposes of gain, loss, depreciation, and so forth, as in the hands of the contributor.

The basis of the contributing partner for his interest in the partnership is to be increased by the basis of the property transferred to the partnership. If the contributed property is subject to indebtedness, the basis of the contributing partner's interest is to be reduced by the portion of the indebtedness assumed by the other partners.

(2) Changes made by committee

Your committee made no changes in this provision.

C. Distributions (secs. 731–736)

(1) House changes accepted by committee

As is indicated below, your committee adopted quite different rules from those provided by the House for the tax treatment of distributions.

Under the House bill, any property distributed by the partnership to a partner would, in general, have the same basis to the distributee partner as in the hands of the partnership, that is, a "carryover" basis. The money and property distributed would be applied in reduction of the basis of the interest of the distributee partner. After the basis of his interest has been used up, any further distribution of money or property would be taxed as capital gain to the distributee.

The distribution of money or property under the House bill would not result in gain or loss to the partnership. Gain or loss was to be recognized to the recipient partner where the basis of any money or property received by a partner exceeded the basis of the partner for his interest in the partnership. The recognition of gain would occur either in a current distribution not affecting the partner's relative interest in the partnership, or in a distribution which reduced or terminated the partner's interest in the partnership. The recognition of loss was limited to a distribution terminating the interest of the partner. In such a liquidating distribution, capital loss was recognized to the extent that the basis of the partner for his interest in the partnership exceeded the basis of the property distributed.

An exception is made to the use of the "carryover" basis where the basis of the property distributed exceeds its value at the time of the distribution. In this situation, the basis of the property to the distributee was to be reduced to the fair market value of the property. The partnership, however, was permitted to retain this "unused basis" and apply it to similar property held by the partnership.

A special rule was provided under the House bill for the purpose of distinguishing bona fide distributions which are subject to the rules discussed above from transactions involving a loan by the partnership to the partner. When a partner is obligated to make repayment to the partnership with respect to money or property received from the partnership, he was to be treated as receiving a loan to the extent of his obligation, and no reduction was to be made in the basis of his interest. If, however, such an obligation was canceled by the partnership without repayment, the partner would then be considered to have received a distribution equal to the amount of debt canceled. The transfer of property subject to an obligation to make repayment was treated as a sale by the partnership, so that gain or loss would be recognized to the partnership.

(*2*) *Changes made by committee*

Your committee has revised the general distribution rules provided by the House bill because of several objections which have been raised with respect to them. It has been pointed out that the assigning to the distributee of the partnership's basis for property distributed in liquidation of his interest and the recognition of gain or loss on the difference between this basis and the basis for his interest in many cases would result in the taxation of gains where there were no real gains and the recognition of losses where there were no real losses.

In lieu of the House rules for distributions, your committee has provided that in the case of liquidating distributions the distributee will substitute for the partnership basis of the property distributed the basis he had for his interest in the partnership. The basis to the distributee of inventory items and unrealized receivables, however, is to be limited to the basis they had in the partnership to prevent the conversion of ordinary income into capital gains. With respect to property other than inventory items or unrealized receivables, the basis of the partnership interest is to be allocated to such property in accordance with the basis of the property to the partnership.

To the extent the basis of the distributee for his interest in the partnership differs from the partnership basis for the distributed property the partnership may (if it has generally elected to make such adjustments) make adjustments to the basis of the property remaining in the partnership to the account of this difference.

The "carryover" provided by the House bill is continued by your committee in the case of nonliquidating distributions. However, instead of realizing gain where this basis for the property distributed exceeds the partner's basis for his interest, your committee's bill provides that the basis of the property distributed is not to exceed the partner's basis for his interest.

An exception to these rules is provided, as an optional arrangement, for a purchaser or transferee of an interest in a partnership. The purchaser or transferee may, in the case of a distribution within 2 years after the acquisition of the interest, apply as the basis of the distributed property the amount which he paid therefor and for partnership property of a like character in which he has relinquished his interest.

These new distribution rules limit quite narrowly the area in which gain or loss is recognized upon a distribution. Gain is to be recognized only where the money distributed is in excess of a partner's basis for his interest; and loss is to be recognized in the case of a liquidating distribution where only money, inventory items and unrealized receivables are distributed and their basis to the partnership is less than the basis of the partner's interest. These rules, combined with the nonrecognition of gain or loss upon contribution of property to a partnership, will remove deterrents to property being moved in and out of partnerships as business reasons dictate.

Your committee was also able to remove the House provision providing special rules where a partner's share of partnerships losses exceeds the basis of his interest by providing in a prior provision that such losses would be recognized to the partner when he repaid to the partnership the excess of the losses not offset by the basis for his interest.

D. Transfers of an Interest in a Partnership (secs. 741–743)

(1) House changes accepted by committee

The House and your committee's bill retain the general rule of present law that the sale of an interest in a partnership is to be treated as the sale of a capital asset. In general, the transfer of an interest will not affect the basis of partnership assets. Provision is made, however, whereby the partnership may elect to adjust the basis of partnership assets to reflect the increase or decrease in the basis of partnership interest transferred by sale or upon the death of a partner. The House bill provides that such an election, once filed, is irrevocable until the termination of the partnership and will require similar basis adjustments with respect to all future transfers of partnership interest. Your committee's bill provides, however, that the Secretary or his delegate may permit a new election. By making adjustments to the basis of partnership assets, the same effect is achieved as though the partnership had dissolved and been reformed, with the transferee of the interest as a member of the partnership. The increase or decrease in the basis of partnership assets may be allocated to such assets in accordance with their respective bases or in any other equitable manner approved by the Secretary or his delegate.

It is to be noted that under the House bill, if the election to increase or decrease the basis of partnership property is made, the change in the basis of the partnership assets will affect all members of the partnership according to their distributive shares and not merely the transferee partner. As indicated below, this is not true in the case of your committee's bill.

(*2*) *Changes made by committee*

In general, your committee has adopted the House provisions relating to transfers. There is one important exception, however. If the partnership elects to adjust the basis of partnership properties with respect to transfers, the adjustment, to the extent it represents appreciation or depreciation in the value of assets after their contribution to the partnership, is to be available only for the transferee partner. Thus, for purposes of depreciation, depletion, gain or loss, and in the case of distributions, the transferee partner, if the partnership elects to make any adjustment, will have a special basis for partnership properties wholly apart from the other partners.

Your committee believes that assigning this special basis largely to the transferee partner is desirable because it is more accurate than the House bill in reflecting the increase (or decrease) in basis to the partner to whom it is attributable. It should be clear, however, that partnerships are not required to make such adjustments if they do not desire to do so.

E. Payments to a Retiring Partner or Successor of a Deceased Partner (sec. 736)

(*1*) *House changes accepted by committee*

When a partner retires or payments are made to the estate or heir of a deceased partner, the amounts paid may represent several items. They may, in part, represent the withdrawing partner's capital interest in the partnership. They may include his pro rata interest in unrealized receivables and fees of the partnership and its potential gain or loss on inventory. Part of such payments may be attributable to an arrangement in the nature of mutual insurance among the partners. The present code contains no provisions relating to the tax treatment of such payments and existing case law presents no consistent approach.

Both the House and your committee's bill provide that when a retiring partner or the successor of a deceased partner receives a share of partnership income in return for the complete relinquishment of his interest in the partnership, the distributions are to be allocated between (*a*) payments for the value of the capital interest and (*b*) other payments. Such allocation will be made in accordance with regulations prescribed by the Secretary or his delegate.

The amounts paid for the capital interest of the withdrawing partner under both bills are treated in the same manner as a distribution. The remaining partners, of course, are allowed no deductions for such payments. Essentially, these payments represent a purchase by the remaining partners of the withdrawing partner's capital interest in the partnership. For this purpose payments for a "capital interest" do not include amounts attributable to a partner's interest in unrealized receivables and fees.

The House and your committee provide different treatment for the portion of the payments to a withdrawing partner which is not made in exchange for his capital interest. Under the House bill these payments are taxable to the withdrawing partner in the same manner as if he continued to be a partner and are excluded in determining the income of the remaining partners. However, the House bill provides that if such payments are continued for a period of more than 5 years after the retirement or death of the partner, they are to be treated as a gift from the remaining partners to the withdrawing partner. As a gift, the payments made after 5 years would be taxable to the remaining partners (with no increase in the basis of such partners for their interest in the partnership) and exempt from income tax in the hands of the recipient. The provision in your committee's bill, which has no 5-year limitation, is described below.

Where a retiring partner receives a lump sum or fixed payments determined without regard to the income of the partnership, the portion of such payments attributable to the capital interest of the retiring partner is to be treated as the purchase of a capital interest by the remaining partners. The balance, however, will be treated like a salary paid by the partnership. It will constitute ordinary income to the recipient and a deduction to the partnership. This part of the provision is the same under both versions of the bill except that payments of this nature, however, are subject to the 5-year limitation.

(2) Changes made by committee

Your committee made one major change in the House provision relating to the treatment of payments to a retiring partner or successor to a deceased partner. The 5-year rule in the House bill has been abandoned. Thus, to the extent that payments to a retiring partner or deceased partner's successor are not in exchange for a capital interest, they are treated as deductions to the remaining partners and as income to the withdrawing partner or his successor irrespective of over how long a period they may be paid. In addition, amounts paid for unrealized receivables and for goodwill (unless the partnership agreement provides otherwise) are also treated as deductions to the remaining partners and as income to the withdrawing partner or his successor.

F. Collapsible Partnership and Other Provisions Common to Distributions and Transfers (secs. 751–755)

(1) House changes accepted by committee

In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests or by distributions of property, certain rules have been adopted by the House and your committee which will apply to all dispositions of partnership interests. The bill provides that if, in connection with the transfer of a partnership interest, the partner receives any amount attributable to his share of (1) the unrealized receivables of the partnership or (2) substantially appreciated inventory or stock in trade, such amount are to be treated as ordinary gain or loss. In effect, the partner is treated as though he disposed of such items independently of the rest of his partnership interest. The same situation exists where a distribution to a partner has the effect of a sale of all or a part of his proper share of receivables or appreciated inventory items.

Since, in the case of a transfer an ordinary income tax is paid by the seller on these items, the purchaser of an interest is permitted under the House bill to exclude from his gross income an amount equal to the income recognized by the seller with respect to such items. This amount was to be spread ratably over the period of time in which it is estimated that the unrealized receivables will be collected or the inventory disposed of, or could be allocated in any other equitable manner which is approved by the Secretary. These exclusions are also available in the case of disproportionate distributions since essentially this also is an exchange. Under your committee's bill this special exclusion is unnecessary because the transferee may have, if the partnership so elects, a special basis for partnership assets.

The term "unrealized receivables" applies to any rights to income which have not been included in gross income under the method of accounting employed by the partnership. The provision is applicable mainly to cash basis partnerships which have acquired a contractual or other legal right to income for goods or services. "Substantially appreciated inventory items" includes any noncapital assets, the value of which exceeds by more than 20 percent the basis of such inventory and exceeds by more than 10 percent the value of all partnership property other than money.

The provisions relating to unrealized receivables and appreciated inventory items are necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income and on appreciated inventory. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The sale of a partnership interest or distributions to partners should not be permitted to change the character of this income. The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.

The House bill provides that a decedent partner's share of unrealized receivables are to be treated as income in respect of a decedent. Such rights to income are to be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. However, a decedent's share of appreciated inventory or stock in trade is not treated as income in respect of a decedent. The decedent's interest in such inventory or stock in trade may be increased or decreased in basis in the same manner as his partnership interest and other property held by the decedent. Any change in the basis of partnership assets will be used by the estate or heir as an adjustment to the income received on the disposition of such property. The estate or heir is thus treated in the same manner as a purchaser with respect to the decedent's interest in appreciated or depreciated inventory or stock in trade. Your committee's bill agrees substantially with the House in the treatment described above but also provides that other income apart from unrealized receivables is to be treated as income in respect of a decedent.

(2) Changes made by committee

Your committee's bill in general follows closely the House bill in the area described above but differs on several points, the more important of which are listed below:

(*a*) No exclusion needs to be provided the transferee or in the case of distributions of unrealized receivables or inventory items since the transferee or partnership may obtain a special basis for such assets or may elect to adjust the basis of partnership property.

(*b*) Substantially depreciated inventory items have been removed from the category of assets receiving separate treatment.

(*c*) The definition of substantially appreciated inventory items has been revised to relate to 10 percent of the value instead of the basis of total partnership assets.

(*d*) The treatment for income in respect of decedents has been expanded to include any payments to a deceased partner's successor not considered a payment for the partner's capital interest.

(*e*) The election to adjust the basis of partnership assets upon a transfer or distribution have been made operative as one election.

G. Effective Dates (sec. 771)

Your committee's bill makes the new partnership provisions generally applicable for partnership taxable years beginning after December 31, 1954, instead of December 31, 1953, as provided by the House bill. However, several loophole-closing provisions are made effective as of March 9, 1954, the date the bill was introduced in the House.

The March 9 effective date applies in the case of—

(*a*) the adoption of a new taxable year by a partner or partnership,

(*b*) the holding period for receivables or inventory items distributed to a partner, and

(*c*) the collapsible partnership provision.

The postponement of the general effective date for 1 year appears desirable to give taxpayers more time to become acquainted with the new provisions. However, the provisions which are loophole closing in character are made effective earlier so that taxpayers will not be given an opportunity to take advantage of the present treatment in this area.

XXIV. Temporary Formula for Taxing Life Insurance Companies (Secs. 801-807)

(1) House changes accepted by committee

Your committee has accepted with minor technical amendments the House bill provisions continuing through 1954 the present temporary formula for the taxation of life insurance companies.

For the past 3 years life insurance companies have been taxed under temporary provisions which apply a flat rate tax of 3¾ percent on the first $200,000 and 6½ percent on amounts in excess of $200,000 of net investment income with certain adjustments. These reduced rates are equivalent to the application of the ordinary corporate rates of 30 percent on the first $25,000 and 52 percent on income above

$25,000, after deduction of 87½ percent of the net investment income. The 87½ percent figure reflects the deduction for the industry's average policy reserve interest needs which would have applied in 1951 under the 1949–50 stopgap formula previously in effect. Under the temporary flat rate tax provisions, companies whose earnings are less than or only slightly above the amount of interest required to meet their own policy obligations receive a special credit which may reduce their tax by as much as one-half. First adopted in 1951 as a temporary expedient, these provisions were successively extended to 1952 and 1953.

Both the House bill and your committee's bill provide the extension of these provisions for 1 more year because with the extensive code revision work it has not been possible to devote the necessary study to the revision of the tax treatment of life-insurance companies. In the absence of the extension the taxation of life-insurance companies in 1954 would automatically revert to an older statutory formula adopted in 1942. Among other defects, the older formula contains no provision for the relief of companies with less than an adequate margin of earnings above interest requirements.

The proposed extension is for 1 year only to provide time in which to work out a sound, long-range formula for the taxation of life-insurance companies. A subcommittee of the Ways and Means Committee has initiated such a study and will make recommendations.

(2) Changes made by committee

Only technical changes were made by your committee to assure the permission for continued use of present accounting methods.

XXV. Regulated Investment Companies

Regulated investment companies which meet various requirements with respect to asset diversification, capital structure and operations and which distribute at least 90 percent of their ordinary income are treated as conduits of income and taxed only on their undistributed income. Dividends paid by such companies are taxed in the usual manner to shareholders except that dividends arising from capital gains realized by the company are identified and receive capital gains treatment in the hands of the recipient. This method permits investors to pool their funds through the use of a corporation in order to obtain skilled, diversified investment in corporate securities without having to pay an additional layer of corporate tax.

A. Definition of regulated investment companies (sec. 851)

(1) House changes accepted by committee

The House bill made no changes in the definition of a regulated investment company. In general a regulated investment company is a company which has elected to be so treated and—

(*a*) is registered under the Investment Company Act of 1940 as a management company or unit investment trust (or in some cases a common trust fund);

(*b*) derives its income principally from dividends, interest, and capital gains; and

(*c*) has diversified its investments in the manner described below.

One-half of its investments must be represented by cash items, Government securities, securities of other regulated investment companies, and by other securities which with respect to any one company—

(a) do not represent more than 5 percent of the value of the assets of the investment company, and

(b) do not represent more than 10 percent of the voting securities of the company issuing the securities.

In addition, not more than 25 percent of the value of the regulated investment company's total assets may be invested in securities (other than Government securities or securities of other regulated investment companies) of one company or two or more companies under the regulated investment company's control and engaged in similar trades or businesses.

(2) *Changes made by committee*

Exceptions are made to the general investment diversification rules described above under present law in the case of investment companies principally engaged in financing so-called development companies. Development companies are defined as companies principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available. A company which is certified by the Securities and Exchange Commission as investing in a development company may, contrary to the general rule for regulated investment companies, hold more than 10 percent of the voting securities of a development company but the regulated investment company under present law is still subject to the limitation that not more than 5 percent of the value of its assets may be invested in any one company. The waiver of the 10 percent voting restriction is, in general, limited to a period of 10 years with respect to any one development company.

It has been pointed out to the committee that although an investment company may initially invest well under 5 percent of the value of its assets in a development company, if the invention, improvement, or process proves successful, the value of this portion of the investment company's assets may increase substantially relative to the value of its other assets. As a result the investment company may soon find that it has more than 5 percent of the value of its assets invested in one company and must, therefore, either forgo the privilege of being taxed as a regulated investment company or must sell a part of the securities in the development company before the end of the 10-year period. The effect of this is to deny continuing investments in development companies which are successful and defeats the purpose for which this provision was originally established.

Your committee believes that it is desirable to require the diversification of the investments of a regulated investment company even where such investments are in development companies. However, it recognizes the problem presented in the testimony before the committee as a real one. For that reason your committee has made the 5-percent limitation which applies to regulated investment companies generally, inapplicable in the case of investments in development companies. In such cases investments are to be limited to 5 percent of the value of the investment company's assets at the time the investment was made. If the investment company initially invests less than 5 percent of the value of its total assets in a development company it may subsequently increase its investments in such company, even though the value of the initial investment rises, so long as the total cost to the investment company of these investments does not exceed 5 percent of the value of its total assets at the time of the second investment.

B. Foreign Tax Credit Allowed to Shareholders (sec. 853)

(1) House changes accepted by committee

Existing law grants citizens and domestic corporations a credit for income tax due for any income, war-profits, and excess-profits taxes paid or accrued to a foreign country. Investment companies having funds invested in foreign corporations, therefore, are entitled to either a deduction from gross income or a credit against tax for foreign taxes withheld on dividends received from foreign corporations.

At the present time, a regulated investment company ordinarily receives little or no tax benefit from the credit for foreign taxes withheld because it does not pay sufficient income tax to utilize the tax credit. This occurs because the company is not taxed on its dividend distributions if it pays out 90 percent or more of its income. As a result investment in foreign stocks through a regulated investment company is at a disadvantage in this respect as compared with direct investment by an individual who can obtain the foreign tax credit. Moreover, failure of present law to pass on the foreign tax credit to shareholders appears inconsistent with the conduit theory on which the tax treatment of these companies is based.

The House and your committee's bill permit the shareholders of regulated investment companies to take the foreign tax credit for foreign income and similar taxes paid on the investment income of the company in the same manner as if they had held the foreign investment themselves. However, the passing on of the foreign tax credit is to be limited to situations in which more than 50 percent of the value of the assets of the regulated investment company is invested in foreign securities. This restriction is added for administrative reasons to deny the passing on of the credit where only incidental holdings of foreign securities are involved.

(2) Changes made by committee

The committee made only minor changes in the House provision to make clear how the shareholder's proportionate share of the foreign tax credit is to be determined and to provide that he may take the credit only if the company has supplied him with the necessary written information within 30 days after the close of the year.

C. Limitations Applicable to Dividends Received From Regulated Investment Companies (sec. 854)

(1) House changes accepted by committee

Under existing law corporate investors in regulated investment companies receive the usual 85-percent dividends-received credit on dividends, including those identified as capital-gain distributions. The purpose of this allowance is to limit the multiple taxation of intercorporate dividends. A considerable part of the dividends may, however, arise from interest on bond investments of the regulated investment company. As a result there is tax avoidance in this area under present law since the corporation which has issued the bonds receives an interest deduction and neither the regulated investment company nor the corporate shareholder of the regulated investment company pay the full tax on the interest income. A similar problem arises in connection with the application to individual shareholders in regulated investment companies of the dividend exclusion and dividends-received credit for individuals contained elsewhere in this bill.

Under the House and your committee's bill, if more than 25 percent of the income of the regulated investment company is from interest or other nondividend income, both the dividends-received deduction for corporations and the dividend exclusion and credit for individuals provided by this bill are to be available only on the portion of the regulated investment company's distributions which actually represents dividend income. If less than 25 percent of the company's income is from interest or other nondividend income, the dividend credits and allowances will apply to the entire distribution by the regulated investment company. Capital-gain dividends distributed by regulated investment companies will not be eligible for either corporate or individual dividend allowances.

(2) *Changes made by committee*

For purposes of applying this section, your committee has defined dividend income to the investment company so as to exclude dividends which would not be entitled to the dividends-received credit or exclusion in the hands of an individual shareholder. It appears to your committee that it is inappropriate to allow the shareholder of a regulated investment company to treat as a dividend for purposes of the credit or exclusion amounts distributed by the investment companies from sources such as dividends paid by foreign corporations, which if received directly by the shareholder would not be eligible for such treatment.

Your committee has also made minor changes in the House provision with respect to the requirements that the investment company notify the stockholder within 30 days after the end of the year as to the amount of any distribution which is eligible for the dividends-received credit or exclusion in the case of individual stockholders and the dividends-received deduction in the case of corporate stockholders.

XXVI. Foreign Income

A. Credit for Foreign Principal Tax (secs. 901, 903)

(1) *House changes*

Existing law provides for a credit, within limitations, against United States tax for foreign income taxes which are defined to include so-called "in lieu of" income taxes. Section 901 (b) (1) of H. R. 8300, as passed by the House of Representatives, allows a credit against United States tax for a tax, designated as a "principal" tax, as defined in section 903. It would be creditable as an alternative to income taxes imposed by the national government of a foreign country. The "in lieu of" income tax concept is eliminated in the House bill.

(2) *Changes made by committee*

Your committee instead of adopting the House proposal has restored existing law.

Objection was raised to the adoption of the principal tax concept on the ground that it would, in many instances, reduce the amount of credit available under existing law and that it would lead to many difficult interpretative problems.

Recognizing these objections as valid, your committee restored the present "in lieu of" provision.

B. Fourteen-Point Rate Reduction for Foreign Income (sec. 923)

(1) House changes

Existing law provides for no differential in tax on foreign and domestic income except for a lower rate of approximately 14 percentage points on income derived by domestic corporations qualifying as Western Hemisphere Trade Corporations. Section 923 of the House bill provides, in the case of domestic corporations, for a reduction in United States tax equal to 14 percent of income from sources within any foreign country which meets the tests provided for in the section. Eligible income would include that received from technical services or from foreign subsidiaries or branches which are engaged in the active conduct of a business in a foreign country. An activity principally devoted to the purchase or sale of merchandise, except at retail, is not a trade or business within the purview of the provision.

(2) Changes made by committee

The bill as reported by your committee contains no provision comparable to section 923 of the House bill.

Your committee is not at this time prepared to adopt the approach to the problem incorporated in the House bill. This is new ground being explored and it presents uncertainties and difficult problems. Your committee has explored various alternative approaches but has been unable to find a solution which appears satisfactory.

Accordingly your committee has omitted the proposal from the bill as reported by it with the thought that exploration of the matter in conference with the House of Representatives will make it possible to adopt a provision which will be satisfactory.

C. Deferral of Tax on Branch Income (secs. 951–958)

(1) House changes

Under existing law, profits of a foreign branch of a domestic corporation are taxed currently. Part IV of subchapter N of the House bill, provides for a procedure whereby domestic corporations may elect to defer tax on income of certain foreign branches in a manner similar to the way in which tax on income of foreign subsidiaries is deferred; that is, foreign income would not be subject to United States tax until brought home. Branches which may be so treated must be engaged in the active conduct of a trade or business meeting the tests prescribed in section 923 of the House bill for foreign corporations whose dividends are entitled to the 14-percent credit. When brought home, the income of such branches would likewise be entitled to the 14-percent credit.

(2) Changes made by committee

The bill, as reported by your committee contains no provision comparable to sections 951–958 of the House bill. Since the proposal to permit deferral of foreign branch income in the House bill is dependent on the requirement that an eligible branch must be engaged in the active conduct of a trade or business entitling it to the 14-percent differential mentioned in the discussion of section 923, your committee believed it advisable to omit this proposal.

D. Elimination of the Overall Limitation on Credit (sec. 904)

(1) House changes accepted by committee

The credit which is now allowed for foreign taxes is subject to two limitations. The per country limitation restricts the foreign tax which may be claimed as a credit to an amount bearing the same proportion to the taxpayer's total tax liability as the income from the foreign country bears to the total income of the taxpayer. The overall limitation applies a similar formula with respect to the aggregate foreign taxes allowed as a credit. As a practical matter, however, the overall limitation is operative only when a taxpayer earns income in one foreign country and incurs a loss in another. The effect of the limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years. Consequently the House has removed the overall limitation.

(2) Changes made by committee

Your committee has approved the House action without change.

E. Definition of Noncorporate Income Earned Abroad (sec. 911)

Where an individual is engaged in a trade or business abroad in which personal services and capital are material income-producing factors, present law provides that no more than 20 percent of the income from the business may be considered "earned" abroad, and hence many qualify for exemption from income tax.

(1) House changes accepted by committee

The House bill increased this percentage to 30 percent, thus affording additional tax relief to businessmen operating foreign business ventures other than in the corporate form.

(2) Changes made by committee

Your committee has approved the House action without change.

F. Western Hemisphere Trade Corporations (sec. 921)

(1) House changes accepted by committee

Although the House believes that the present Western Hemisphere trade corporation provisions produce some anomalous results, it retained those provisions in order to avoid any disturbances at the present time to established channels of trade. However, to correct an obvious inequity which has arisen in the administration of this provision, the House bill provided that incidental purchases made outside of the Western Hemisphere will not disqualify a corporation from the Western Hemisphere trade corporation credit if it is otherwise eligible for it.

(2) Changes made by committee

Your committee has approved the House action without substantial change. It did indicate, however, that the House change is to have no effect prior to January 1, 1954.

G. Other Changes

(1) House changes

In addition to the revisions involving foreign income which have already been described, the House bill made a number of minor changes affecting nonresident aliens employed abroad by American firms who come to the United States for temporary periods, China Trade Act corporations, royalties received under certain conditions from a foreign subsidiary, and the statute of limitations applicable to claims for refunds by taxpayers assessed abroad for additional taxes.

(2) Changes made by committee

Your committee has approved these provisions with changes in some instances. The details of your committee's action is explained in the technical discussion of the bill in a later section of this report.

II. Revenue Effect

It is estimated that the provisions dealing with foreign income would involve a revenue loss of $2 million in the fiscal year 1955. This is attributable to the removal of the overall limitation.

XXVII. Gain or Loss on Sale of Property

A. Change in Basis of Property Acquired From a Decedent (sec. 1014)

(1) House changes accepted by committee

Under existing law most property transferred as a result of the death of an individual receives a new basis at the date of death equal to its then market value (or value 1 year later if the estate-tax optional valuation date is used). This is presently true in the case of property acquired directly from the probate estate of the decedent as well as to property transferred by certain other specifically described transfers. This change in basis is not available, however, with respect to property included in the decedent's gross estate for estate-tax purposes if the property was transferred in contemplation of death, was acquired by the surviving tenant of a joint tenancy or tenancy by the entirety, or was included in the gross estate as a reserved income transfer.

There appears to be no justification for denying some property included in a decedent's gross estate for estate-tax purposes a new basis at date of death while giving this new basis in most other cases.

The House and your committee's bill remove this discrimination by providing a new basis at date of death (or 1 year later if the optional valuation date is used) for nearly all property includible in the decedent's gross estate for estate-tax purposes. The only exceptions to this general rule are income in respect of a decedent, including unexercised restricted stock options and the interest element in a survivor's interest in a joint and survivor annuity accruing since the annuity was purchased. Under that provision when the income is reported for income-tax purposes by the estate or beneficiary, a deduction is allowed for any estate tax attributable to the values included in the decedent's gross estate. This is a substitute for the new basis at death.

The changes made by the House and your committee in this provision are applicable to property received from an individual dying after December 31, 1953.

(2) Changes made by committee

Your committee made substantive amendments to this provision as passed by the House as well as several technical changes. Your committee added a specific rule for determining the basis of property transferred before the death of the decedent. So that the donee will not receive a double deduction it is provided that his new basis will be the value of the property at the date of the decedent's death (or alternative valuation date if applicable) less the total of his deductions for depreciation, depletion, and amortization of property he received by gift. This rule will not involve the recomputation of the deductions already taken for the period prior to the decedent's death.

B. Adjustment to Basis (sec. 1016)

(1) House changes accepted by committee

Where a tax-exempt organization which has held a property for a number of years becomes taxable (as in the case of the application of the unrelated business income tax since the Revenue Act of 1950) questions have been raised as to what basis the property should have for purposes of computing depreciation for income-tax purposes. The alternatives available are the original cost of the property, its fair market value at the time the organization becomes taxable, or its cost less depreciation and obsolescence which has taken place during the interval prior to the time when the organization becomes taxable.

The present code does not deal specifically with this problem. The rule presently followed by the Internal Revenue Service is the third alternative described above. The House and your committee have endorsed the position taken by the Service by specifically providing in the new code that the basis of the property, for purposes of computing taxable income, is reduced for exhaustion, wear, tear, obsolescence, amortization, and depletion to the extent sustained during any period since 1913 when the property was held by an organization not subject to income taxation.

(2) Changes made by committee

The committee made no substantive changes in this provision.

C. Sale of an Annuity Contract (sec. 1021)

(1) House changes accepted by committee

The House and your committee have added a provision to prevent the operation of the new rule for taxing annuities from resulting in a basis of less than zero in the case of a sale of an annuity contract.

(2) Changes made by your committee

No changes were made by your committee.

D. Exchange of Property Held for Productive Use or Investment (sec. 1031)

Your committee added section 112 (b) (2) of present law which provides for tax-free exchanges of common stock for common, and of preferred stock for preferred, in the same corporation. Since a similar provision was eliminated from subchapter C of the House bill, its insertion at this point does not represent any change.

E. Involuntary Conversions (sec. 1033)

(1) House changes accepted by committee

Your committee approved the change made by the House which extends the involuntary conversion provision to property used by a taxpayer as his principal residence. This provision is described in section 1034 below.

(2) Changes made by committee

It also added a new provision which treats as an involuntary conversion the sale of land owned by an individual in excess of the maximum allowable under acreage limitations of Federal reclamation laws.

F. Sale or Exchange of a Residence (sec. 1034)

(1) House changes accepted by committee

The Revenue Act of 1951 eliminated in most cases the immediate recognition of a capital gain on the sale of a taxpayer's principal residence, provided that the proceeds are used to acquire a new residence. In the case of qualifying sales the basis of the old residence is carried over to the new residence. To qualify under this provision the taxpayer must purchase and occupy another residence within 1 year of the date of the sale, unless he builds a new residence, in which event the period is 18 months. The House and your committee have continued this treatment of homeowners in the new code, but made four minor modifications.

Present law provides that gain is recognized only to the extent that the selling price of the old residence exceeds the cost of the new. However, the selling price may not be reduced by the expenses of sale. For example, an individual may sell an old house, with a cost basis of $10,000, for $14,000, incur selling expenses of $1,000 and reinvest the net proceeds of $13,000 in a new home. In such a case, a fictitious gain of $1,000 would be recognized, because the selling price of the old house exceeds the cost of the new by this amount. Under both versions of the bill, this result is avoided by reducing the selling price, for purposes of recognizing gain by selling expenses.

Often a homeowner must incur certain fixing up expenses (such as papering and painting) in order to sell his house which may not otherwise be deductible or which may not represent capital expenditures and thus have no effect on the basis of the house. Both versions of the bill provide that such expenses (incurred for work performed within a 90-day period prior to the contract of sale and paid for within 30 days after the sale) may also reduce the selling price for purposes of recognizing gain. These are allowed since they are incurred only to sell the old house.

Under existing law in the case of the involuntary conversion of property which consists partially of a personal residence and partially of a business property, the permissive extension of the replacement period beyond 1 year is applicable to the business portion, but the residence portion must be replaced within 1 year. In cases of involuntary conversion, this discrepancy in treatment has required some taxpayers (such as farmers), who own properties which are both residences and business properties, to replace the entire property within 1 year or lose the benefits of the postponement of gain. To prevent this effect the House and your committee's bill provide that involuntary conversions of residences are to come under the general involuntary conversion provision under which the Secretary or his delegate can extend the replacement period beyond the 1 year, or 18 months, allowed in the case of residences.

Present law provides that the replacement period with respect to members of the Armed Forces is suspended during the time the taxpayer or his spouse is on extended active duty after the date of sale of the old residence and before January 1, 1954. In view of the continuance of the draft and the recall of Reserves to active service, the House and your committee have eliminated the cutoff date of January 1, 1954, but continues to limit the suspension to a period of 4 years from the date of the sale of the old residence.

(2) Changes made by committee

None.

G. Mortgage Foreclosures (sec. 1035 of the House bill)

Your committee has decided to reject provisions of the House bill dealing with mortgage foreclosures and related transactions. The approach under the House bill provided that in the case of foreclosures no gain or loss would be recognized until the creditor disposed of the property. Under this treatment, the foreclosed property would take the debt as its tax basis, and the gain or loss on its ultimate disposition by the creditor would be capital or ordinary, depending on the previous character of the mortgage or other evidence of indebtedness in the hands of the creditor.

The action of your committee in this regard was governed by the concern expressed by various taxpayer groups that the proposed House treatment in its application to the complex area of creditor-debtor relationships might operate so as to unduly defer or in some cases deny appropriate loss deductions. In eliminating this provision, the committee has restored present law, which, in general, treats a mortgage foreclosure as a taxable sale and determines the gain or loss with reference to the difference between the value of the foreclosed property and the portion of the loan satisfied by the foreclosure.

H. Exchange of Insurance Policies (sec. 1035)

(1) House changes accepted by committee

Under present law, where one insurance policy is exchanged for another, the excess of the value of the policy received over the premiums paid for the exchanged policy is taxable. This has resulted in the taxation of individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain. To remedy this situation, the House and your committee's bill provide that no gain or loss is to be recognized on the exchange of—

(1) a life insurance contract for another life insurance contract or for an endowment or annuity contract;

(2) an endowment contract for another endowment contract or for an annuity contract; and

(3) an annuity contract for another annuity contract.

(As indicated below, however, your committee has placed limitations on the tax-free exchange of one endowment contract for another.)

In the three types of nontaxable exchanges listed above, the contract received by the taxpayer will take the basis of the contract exchanged for it, with adjustments for other payments accompanying the transfer. Thus, if the exchange concerns contracts whose proceeds are taxable, any gain on the original contract, which is not recognized at the time of the exchange, will be taxed when the proceeds of the second contract are realized.

However, when an endowment contract is exchanged for a life insurance contract, gain will continue to be recognized at the time of the exchange. This is to prevent avoidance of the tax due on the maturity of endowment contracts by conversion to life insurance contracts whose proceeds, payable at death, are free of tax.

(2) Changes made by committee

The House bill provided that no gain or loss would be recognized on the exchange of an endowment contract for another endowment or annuity contract. To prevent tax avoidance, your committee changed this provision to allow the tax-free exchange of an endowment contract for another endowment contract only if the contract received will provide regular payments beginning before or on the same date as the contract exchanged.

XXVIII. Capital Gains and Losses

As in the House bill, your committee's bill does not involve a basic change in the treatment of capital gains and losses. The House bill did make some changes in the application of the capital gains tax in the case of certain special types of assets or transactions. Your committee's bill has accepted most of these changes with some modification at a few points. Two of the sections that were new in the House bill were completely abandoned.

A. Definition of Capital Asset To Exclude Certain Accounts and Notes Receivable (sec. 1221)

(1) House changes accepted by committee

Under present law a taxpayer is required to take into income the value of an account or note receivable acquired in the sale of inventory or stock in trade, or in connection with the rendering of services. Unless the taxpayer is a dealer in accounts and notes, however, he receives only a capital loss if he sells the account or note for less than he previously took into income. Since this in effect is a business bad debt, ordinary loss treatment appears appropriate.

The House bill provides ordinary loss or income treatment where an account or note, acquired in the manner described above, is sold or exchanged. This is the treatment presently applicable if the account or note is held until maturity.

(2) Changes made by committee

The change proposed in the House bill has been accepted by your committee with only technical amendments.

B. Holding Period (sec. 1223)

(1) House changes accepted by committee

Present law, in determining long- or short-term capital gains and losses, permits the holding period of an asset given up in a tax-free exchange to be added to the holding period of an acquired asset. To prevent tax avoidance the House bill permits the adding of the two holding periods only where both assets are capital assets.

Under both present law and the bill, a taxpayer who holds a commodity futures contract for more than 6 months, and then sells it, has a long-term capital gain or loss. However, under present law if at any time he accepts delivery of the commodity, his holding period starts again as of that time. The bill provides that delivery in such a case does not start a new holding period.

The House bill also permits stock acquired in a spin-off to include the holding period of the basic stock from which the spin-off was made.

(2) Changes made by committee

The House bill provided, prospectively, that in determining the holding period of property acquired in a spin-off there shall be tacked on the holding period of the underlying security. Your committee has made clear that this will apply even where the spin-off occurred prior to January 1, 1954, as long as the spun-off stock is sold in a year to which the new code applies.

Your committee has slightly modified the rule for "tacking-on" in tax-free exchanges generally by amending the House bill requirement that both assets be capital assets, to allow tacking-on if the asset exchanged is depreciable property used in the trade or business.

(C) Bonds and Other Debt (sec. 1232)

(1) House changes accepted by committee

Under section 117 (f) of present law, when a corporate or Government bond in registered form or with coupons attached is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i. e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount (see I. T. 3486, 1941-2, C. B. p. 76, as compared with *Comm.* v. *Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

Effective with respect to bonds issued after December 31, 1954, the House bill removes doubt in this area by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. This is, of course, not intended to have any effect with respect to bonds issued before that date. This discount is apportioned over the entire period to the maturity of the bond and if the bond is sold prior to maturity only a pro rata portion of this discount is attributed to the gain realized by the seller. Any excess gain over the amount considered as ordinary income will be taxed as a capital gain. This rule is not applied to State and local government securities since interest income on these securities is free of tax. Rules for determining the original issue price are provided by the bill.

(2) Changes made by committee

Your committee has extended the underlying principle of the House bill to another situation where a discount is created in connection with a bond by means of an artificial transaction. Where a bond is sold with a number of coupons detached in addition to the coupons covering the next 12 months, an artificial discount is created. The bill provides that the buyer of such a bond with excess coupons detached will report as ordinary income any gain on the later sale or redemption of the bond up to the amount of the artificial discount created by detaching coupons.

Several clarifying amendments have been made to make clear the application of the provisions of this section in the case of so-called face-amount certificates where the investor makes a series of payments with an agreement to receive a larger lump sum at the end of a period of time. This difference is to be treated as original issue discount.

Certain changes have been made in the House provision for administrative convenience to avoid the application of the formula in several situations where little or no ordinary income is likely to be recognized.

D. Short Sales and Options (secs. 1233, 1234)

(1) House changes accepted by committee

Under present law, a dealer in commodities or securities can obtain long-term capital gains treatment by selling his stock in trade short rather than by selling it outright. To prevent tax avoidance, the House bill provides that the gain or loss from a short sale is to depend upon the nature of the asset used to close the sale.

Under present law in the case of the failure to exercise an option the holder of the option always realizes a short-term capital loss and the grantor a short-term capital gain; in the case of the sale of an option the holder (unless a dealer in options) realizes a long or short-term capital gain or loss depending on how long he held the option. The House bill provides consistent treatment for sales and failures to exercise an option and in the case of the optionee makes the treatment depend on the nature of the underlying asset. Thus, if a taxpayer acquires an option relating to a noncapital asset he will receive an ordinary gain or loss when he sells the option or when the period expires for him to exercise it; or if the underlying asset is a capital asset he will receive capital gain or loss treatment regardless of how he disposes of the option. However, the grantor of the option always will receive ordinary income on the failure to exercise any option.

Present law does not count as a part of a holding period any period in which a taxpayer is both long and short with respect to substantially the same investment. Moreover, present law provides a presumption that a "put" (an option to sell an asset at a fixed price) is a short sale. This prevents the use of a "put" to artificially extend a speculative commitment beyond 6 months. However, if a "put" is purchased with the stock which is to be used to exercise it in order to hedge against a decline in its value, the taxpayer is denied long-term capital gains treatment. To avoid this result a "put" is not to be presumed a short sale if, among other things, it is purchased at the same time as the stock to be used to fulfill the contract.

(2) Changes made by committee

Your committee made no changes in this section.

E. Sale of Patents by an Inventor (sec. 1235)

(1) House changes accepted by committee

Under present law an amateur inventor may receive capital gains treatment on the outright sale of his patent but a professional may not. However, if a sale arrangement results in royalty income, rather than installment payments, even an amateur inventor faces uncertainty as to whether he receives capital gains or ordinary income tax treatment.

The present distinction between amateur and professional inventors and between royalty income and installment payments is both arbitrary and confusing since, due to the inherent uncertainties, a royalty type of arrangement is the reasonable way for an inventor to sell a patent. Moreover, the present treatment tends to discourage scientific work.

The House bill made no distinction between amateur and professional inventors or between royalty income and installment sales. Capital gains treatment was to be available in all such cases if the contract does not make the sales price dependent, for a period of more than 5 years, upon the productivity, use, or disposition of the patent in the hands of the buyer, and if the payments are completed in 5 years (except for late payments resulting from the failure of the buyer to meet the contract terms). The statute of limitations was extended for this purpose. These restrictions were drastically revised by your committee.

(*2*) *Changes made by committee*

Your committee did not feel that the House bill accomplished its objective of stimulating inventions because section 1235 was restricted to the inventor and because of the 5-year rule. The section has been amended so as to apply also to an individual who purchased his interest in the invention prior to the point in time when the invention is reduced to actual practice, but this individual may not be a close relative nor an employer of the inventor. The provisions of the House bill were amended further to remove the 5-year rule. This means that any income from an assignment or an exclusive license agreement which qualifies as a sale or exchange, in the hands of a qualified assignor or licensor, will be capital gains, whether or not it depends on the profitable use of the patent by the assignee or licensee.

(*F*) *Investment Account of Real Estate Dealers* (*sec. 1237 of House bill*)

(*1*) *House changes accepted by committee*

Your committee deleted this provision. Real estate dealers are not given specific opportunities under present law to segregate their personal investments in real estate from their real estate business activities. Such segregation in their cases is generally limited to occasional instances of inherited property or unrelated types of real property investment.

The House bill extended capital gain treatment to real estate dealers who earmark property for investment (within 30 days of acquisition or 90 days after the enactment of this provision) if no substantial improvements are made to the property by the dealer and if the property is held for a period of at least 5 years.

To separate the long-term gain element from the ordinary income attributable to the selling effort, the bill provided that, to the extent of 5 percent of the gross proceeds of the sale, ordinary income is realized and only the remaining gain is to be treated as a capital gain from an investment. Expenditures of the sale were to be allocated first to the portion of the gain treated as ordinary income.

(*2*) *Changes made by committee*

This section has not been retained in your committee's bill. The provision in the House bill was criticized as being unduly restrictive with respect to the sort of improvements that could be made by the investor-dealer. It was considered appropriate to subject this problem to more detailed analysis and to avoid adopting language at this time that would be unnecessarily restrictive or allow tax avoidance.

(G) Sale of Subdivided Real Estate (sec. 1237)

(1) House changes accepted by committee

At present, an individual who subdivides real property held for investment purposes is likely to be held a dealer and subjected to ordinary income tax rates on the entire long-term gain. However, an individual holding real property for investment may find that the only way to dispose of it at a reasonable price is to subdivide it into lots.

The House adopted a provision which permits a taxpayer subdividing real estate under special circumstances to report long-term capital gains on the sales of lots. To obtain this treatment the taxpayer must not be otherwise a dealer in real estate, must not have made a substantial improvement in the property, and must have held the property for 5 years. In such cases the first five sales may be made subject only to capital gain or loss treatment. In the year in which the sixth sale is made, and in any subsequent sales of the property, the subdivider is to report 5 percent of his gross proceeds of all such sales as ordinary income and any remaining gain as capital gain.

(2) Changes made by committee

Your committee has amended the rule relating to substantial improvements on the property. For an improvement to exclude a particular subdivided parcel of the tract from the benefits of this section, the improvement must be on the tract, it must substantially enhance the value of the parcel sold, it must itself be substantial in character, and it must be put up under circumstances that involve an adjustment to basis for the holder of the tract.

H. Certain Employee Termination Payments (sec. 1240)

(1) House changes accepted by committee

This section is derived from section 117 (p) of present law but was not included in the House bill.

(2) Changes made by committee

Your committee agrees with the objective of removing this provision prospectively but took that action in such a way as not to affect individuals who prior to 1954 entered into employment contracts relying on the application of this provision.

I. Cancellation of Lease or Distributor's Agreement (sec. 1241)

(1) House changes accepted by committee

This provision was not included in the House bill.

(2) Changes made by committee

Your committee has taken action to assure that certain types of transactions will be regarded as sales and thus may give rise to capital gain or loss. For the most part, these results are achieved in the courts at present. This section provides that amounts received by a lessee in payment for giving up his business lease will be regarded as proceeds of sale. Also, amounts received by a distributor for surrendering his distributor's agreement will also be so considered if he has a substantial capital investment in the distributorship.

The section is limited in scope and it does not constitute a reexamination of present law relating to contracts to which the section does not specifically apply.

J. Private Annuities (sec. 1241 in House bill)

(1) House changes accepted by committee

The bill as passed by the House, but not your committee's bill, formulated specific rules for the tax treatment of private annuities. So-called private annuities or noncommercial annuities involve the exchange of property for a promise on the part of the buyer to pay a life income. Presently, the tax treatment of these transactions is in an uncertain status due to conflicting court decisions.

(2) Changes made by committee

Your committee has not adopted this portion of the House bill. The objective of clarifying the uncertainty of the court decisions is praiseworthy. It was found, however, that the application of the rules of the House bill left some uncertainty in particular areas, notably in support contracts. It was considered preferable to give more attention to the operation of the proposed new rules in various types of situations before they were adopted.

XXIX. Readjustment of Tax Between Years

A. Averaging (secs. 1301-1304)

(1) House changes accepted by the committee

Your committee adopted the several amendments to existing law in the House bill. One of these changes increases the maximum time over which income from an invention can be spread back from the present 36 months to 60 months. Another provides that a partner cannot spread back income to years prior to his becoming a member of the partnership. A third provision denies the benefits of income-splitting for years prior to 1948. As under present law, this provision would only be available if the income is earned over at least 36 months.

(2) Changes made by committee

In addition, the committee's bill provides that income from inventions and artistic work may be spread back for income tax purposes if earned over a period of 24 months instead of over the 36-month period provided by present law.

B. Adjustments to Closed Taxable Years (sec. 1311-1315)

(1) House changes accepted by committee

Under existing law an adjustment of the tax may be made for years otherwise barred by the statute of limitations where either the taxpayer or the Commissioner of Internal Revenue maintains an inconsistent position in an open taxable year. This prevents either party from gaining a tax advantage by adopting an inconsistent position. An adjustment is also permitted in closed taxable years under certain conditions where the taxpayer claimed a deduction in the wrong taxable year or the Commissioner included an item of income in the wrong year.

The amendments made by your committee are designed to provide a simplified procedure for making the adjustments, to reflect the net operating loss in the computation of the adjustment, and to provide for more uniform application of the circumstances under which the adjustment is allowed.

At the present time the adjustment to closed taxable years may be made only on the basis of a final determination of the tax liability with respect to the open year. The final determination must be either a decision of a court, a closing agreement, or a formal allowance or disallowance of a refund claim.

The House and your committee has provided that adjustment in the closed year may be made on the basis of an informal determination signed by the taxpayer and on behalf of the Commissioner. The new procedure will be subject to regulations approved by the Secretary or his delegate. The informal determination will not be binding on the parties, but if the determination should later be altered or revoked, the adjustment in the closed year will also be revised. The proposed procedure will eliminate the present confusion as to the status of informal agreements and enable taxpayers and the Government to obtain speedy relief in cases where the application of the adjustment provision is agreed to by the parties.

The amount of the adjustment under present law is determined solely on the basis of the computation of tax for the year of the error. It has been pointed out that the adjustment may be wholly inadequate in cases where a net operating loss is involved which affects other taxable years. The adjustment provisions have been amended accordingly to provide that there shall be taken into account the effect in other taxable years of a net operating loss deduction or a capital loss carryover which is determined with reference to the year of the adjustment.

Other technical amendments have been made to the provisions describing the circumstances under which the adjustment to closed taxable years may be made. For example, the adjustment will be available, in cases involving the determination of the basis of property, where either the taxpayer or the Commissioner assumes an inconsistent position with respect to the expensing of items which are properly chargeable to capital account, or the capitalizing of items which should have been expensed. The provisions relating to the treatment of property held by donees have been revised to make the adjustment applicable where the donor owned the property at the time of the erroneously treated transaction. Under present law the adjustment as to donors is applicable only where the donor acquired the property in the erroneously treated transaction.

(2) Changes made by committee

Your committee made only technical changes in this provision.

C. Involuntary Liquidation of LIFO Inventory (sec. 1321)

(1) House change accepted by committee

Under existing law taxpayers on the LIFO inventory basis are given special treatment in the case of involuntary liquidations of inventories occurring after January 1, 1950, and before January 1, 1954, and related to war conditions or to the disruption of normal trade channels which caused a scarcity of the inventory goods, provided that replacement is made prior to January 1, 1956. If these conditions are met, an appropriate adjustment is allowed for the year of liquidation to cover the cost of replacing that inventory in the later year.

The House and your committee's bill provide that this treatment may be applied to involuntary liquidations occurring in any taxable year ending before January 1, 1955, since the continued war in Asia is still forcing the involuntary liquidations of inventories. This section has not otherwise been changed from present law.

(2) Changes made by committee

None.

D. Claim of Right (sec. 1341)

(1) House changes accepted by committee

Under present law if a taxpayer is obliged to repay amounts which he had received in a prior year and included in income because it appeared that he had an unrestricted right to such amounts, he may take a deduction in the year of restitution. In many instances of this nature, the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.

The House and your committee's bill provide that if the amount restored exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution. The $3,000 limitation is imposed for administrative reasons. Moreover, with amounts of $3,000 or under, the effect of excluding the repaid amount from the earlier year's income is likely to have little, if any, tax advantage over taking a deduction in the year of restitution. This section is inapplicable to refunds, allowances, bad debts, etc., pertaining to sales of inventory or stock in trade which may be provided for under section 462 relating to reserves.

(2) Change made by committee

Your committee's bill provides that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility where the refunds are required to be made by the regulatory body, such as the Federal Power Commission. It is made clear, for example, that refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

XXX. Election of Certain Corporations and Unincorporated Businesses as to Taxable Status

Your committee has adopted new provisions which for the first time will eliminate the effect of the Federal tax laws on the form of organization adopted by certain small businesses. This is accomplished by giving certain corporations the option to be taxed as a partnership and by allowing certain proprietorships and partnerships the option to be taxed as a corporation. These provisions are not in the House bill.

A. Certain Corporations Electing to be Treated as Partnerships (sec. 1351)

(1) House change

No provision of this type is in the House bill.

(2) Changes by committee

Under your committee's bill certain corporations organized after December 31, 1953, may elect to be treated for tax purposes as a partnership. This election is limited to corporations with 10 or fewer shareholders, all of whom are actively engaged in the business. The consent of each shareholder is required and no change may be made in the election unless there is a change in ownership of more than 20 percent. In order to avoid possible complications in the taxation of preferred stock dividends not earned in the year distributed, only corporations having one class of stock outstanding may qualify. Moreover, employees of the corporation who are shareholders would not be permitted to participate in tax-exempt employee pension or profit-sharing plans.

This provision will make it possible for small corporations which are essentially partnerships to enjoy the advantages of the corporate form of organization without being made subject to possible tax disadvantages of the corporation. It will thus eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances.

It is estimated that giving certain corporations the election to be treated as partnerships will decrease revenues in the fiscal year 1955 by $50 million.

B. Unincorporated Business Enterprises Electing To Be Taxed as Domestic Corporations (sec. 1361)

(1) House changes

No provision of this type is in the House bill.

(2) Changes made by committee

This provision of your committee's bill permits certain proprietorships or partnerships with 50 or less members to elect to be treated for tax purposes as a corporation. This privilege is limited to those businesses where capital is a material income-producing factor, or where 50 percent or more of the gross income consists of gains, profits, or income derived from trading as a principal or from certain types of brokerage commissions. This provision would rule out firms engaged in professional services such as the law, accounting, medicine, engineering, and others. Since it is intended to limit optional tax treatment to operating business income, personal holding company income such as dividends, interest, and certain rents and royalties, are excluded from corporate income-tax treatment and are taxed directly to the proprietor or partners as if an election had not been made.

An election to be taxed as a corporation is to be irrevocable unless there is a change in membership of more than 20 percent.

The privilege of unincorporated businesses to be treated as corporations for tax purposes is complementary to the similar option granted certain corporations. It permits the business to select the form or organization which is most suitable to its operations without being influenced by Federal income-tax considerations.

It is estimated that giving unincorporated business enterprises the election to be taxed as corporations will decrease revenues in the fiscal year 1955 by $20 million.

XXXI. Consolidated Returns (Secs. 1501–1505)

(1) House changes

The House changes which were not accepted by your committee are discussed below.

(2) Changes made by committee

Under the House bill, the consolidated return regulations were inserted in the statute. While your committee recognizes that these regulations have been generally accepted, your committee believes that it is more appropriate to have these detailed rules in the form of regulations rather than in the statute. In this form they may be readily amended without necessary congressional action. This is particularly desirable in view of the many revisions of the income tax laws in this bill which must be reflected in these regulations.

In returning, in effect, to the existing law in this area, your committee provides that in order for corporations to join in the filing of a consolidated return, one must own 95 percent of the outstanding stock of the other. The House bill lowers this stock ownership affiliation test to 80 percent.

While your committee and the House bill generally retain the 2 percent additional tax on the income of an affiliated group exercising the privilege of filing a consolidated return, your committee has provided that this additional tax shall not apply in the case of an affiliated group consisting of regulated public utilities.

It is estimated that removing the 2 percent additional tax on regulated public utilities will reduce the revenues in the fiscal year 1955 by $35 million.

XXXII. Disallowance of Minimum Exemption and Credit (Sec. 1551)

(1) Changes accepted by committee

Under present law, if a corporation transfers property (other than money) to another corporation which it controls and which was created or utilized for the purpose of receiving the transferred property in order to obtain either an additional $25,000 minimum surtax exemption or an additional $25,000 minimum excess profits tax credit, the benefit of the additional credit or exemption is disallowed to the transferee corporation. Under existing law, this provision is not applicable with respect to taxable years beginning after December 31, 1953.

Your committee and the House bill extended this provision indefinitely insofar as it relates to the $25,000 minimum surtax exemption. The House bill also provides that the $30,000 accumulated earnings credit provided by your committee in connection with the tax on accumulated earnings, also is not to be available to the transferee corporations in these cases.

(2) Changes made by committee

Your committee made a technical conforming change increasing from $30,000 to $60,000 the amount of the accumulated earnings credit to which this provision refers.

XXXIII. Estate Tax

Substantive changes have been made in the estate tax by the House and your committee. However, the basic structure of this tax has been retained and the rates in effect under present law have been continued.

A. Combining the Basic and Additional Taxes (secs. 2001 and 2011)

(1) House changes accepted by committee

Under present law estate-tax liability is computed by first determining a "tentative tax" (basic and additional taxes). Then, if the estate is over $100,000 a "basic estate tax" is computed and 80 percent of this represents the maximum credit allowed for State death taxes.

The House and your committee's bill greatly simplifies this computation by doing away with the necessity of separately computing the basic tax. This is made possible by expressing the maximum credit allowable for State death taxes as a percent of the taxable estate of the decedent.

This simplified method of computing the tax does not change the tax liability of any citizen or resident of the United States or the credit allowed for State death taxes. It does, however, raise slightly the tax of those few nonresident aliens who are entitled to a credit for State death taxes.

While the concept of the basic estate tax is largely discarded in the bills, a method of determining the basic and additional estate taxes separately is retained, since some State death taxes and the exemption for estates of certain members of the Armed Forces require the separate computation of these taxes.

(2) Changes made by committee

None.

B. Credit for Tax on Prior Transfers (sec. 2013)

(1) House changes accepted by committee

Present law allows a deduction for property received from a prior decedent (or by a gift subject to tax) within 5 years of the current decedent's death. The deduction is allowed for the value of the property still in the possession of the current decedent at the time of his death (or which can be traced as having been acquired in exchange for such property) and is independent of the amount of the tax paid on the prior transfer. The deduction is reduced if the property is subject to a debt or claim and no deduction is allowable if the property was received from the current decedent's spouse.

Your committee has accepted a House provision which will give more equitable results and remove the difficult task of tracing the property. A credit is allowed for the tax paid on the property in the estate of the prior decedent but it can never be larger than if the current decedent had not received the property. To eliminate the tracing the credit is based upon the value of the property at the time of the death of the prior decedent. Moreover, property transferred between spouses, to the extent no marital deduction was available, is eligible for this credit.

The credit is to be allowed in full for 2 years following the death of the prior decedent and then decreases by 20 percent every 2 years thereafter until no credit is allowed after the 10th year.

Since the purpose of this provision is to prevent the diminution of an estate by the imposition of successive taxes on the same property within a brief period, the credit for gift tax paid on a prior transfer has been omitted.

(2) *Changes made by committee*

Your committee has expanded the provisions in the House bill in minor respects. It specifically includes property passing as a result of the exercise or nonexercise of a power of appointment. This removes any possibility that property includible in the estate of a donee of a power of appointment will be taxed twice if the appointee or taker in default dies within 10 years of the donee. In addition, your committee provided that inter vivos transfers to a person who predeceased the transferor by less than 2 years may qualify. Under the House bill, for example, if A made a gift to B in contemplation of death and the property was included in A's gross estate, no credit would have been available to either A or B if B predeceased A. To meet this problem without creating undue administrative difficulties, a credit in this example will be given to B if he died within 2 years before the death of A or 10 years after.

In order to provide more certain rules under which property is valued for the purposes of computing the credit and the limitation of the credit under this section, your committee struck the provisions in the House bill on this matter and inserted new rules based on the principles established under the estate tax marital deduction. However, the distinction between terminable interests and other interests made in the case of the marital deduction is not continued in this section, since the terminable interest may have produced income that might be taxable in the decedent's estate. Thus, if A transfers a life estate in property to B, and the remainder interest to C, the value of the life estate at the time of A's death would form the basis for the computation of B's credit for the estate tax paid on the transfer by A, and the value of the remainder interest at the time of A's death would be used in determining C's credit.

C. Alternate Valuation (sec. 2032)

(1) *House changes accepted by committee*

Your committee rejected all substantive changes made in the section by the House bill.

(2) *Changes made by committee*

Present law allows an estate to be valued at either the date of a decedent's death or 1 year thereafter. The value of the property on the valuation date selected is also used to determine the income tax basis for the property in the hands of the transferee.

The House bill would have limited this option to instances in which the property declined by one-third in value during the year after death. This proposal would have had the unfortunate effect of compelling litigation to determine the value at two dates. In addition, it would have provided a severe hardship in the case of an estate which declined in value substantially but not quite by one-third. Therefore, your committee's bill reinstates the provisions in present law.

D. Transfers Taking Effect at Death (sec. 2037)

(1) House changes accepted by committee

Under present law property previously transferred by a decedent is includible in his gross estate if possession or enjoyment of the property can be obtained only by surviving him. This rule applies even though the decedent has retained no interest in the property.

Where the decedent has disposed of all, or substantially all, of his rights to property long before his death, it appears unduly harsh to subject the property to estate tax merely because the ultimate taker of the property is determined at the time of the decedent's death.

This rule has been discarded by the House and your committee's bill. In the future property previously transferred by a decedent will be includible in his estate only if he still had (either expressly or by operation of law) immediately before his death a reversionary interest in the property exceeding 5 percent of its value, that is, if he, prior to his death, had 1 chance in 20 that the property would be returned to him.

(2) Changes made by committee

None.

E. Annuities (sec. 2039)

(1) House changes accepted by committee

Under present law the value at the decedent's death of a joint and survivor annuity purchased by him is includible in his gross estate. It is not clear under existing law whether an annuity of that type purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contributions is includible in the decedent's gross estate.

The House and your committee's bill requires the inclusion of a joint and survivor annuity in the gross estate to the extent that the decedent contributed to its cost and, for the purpose of determining the extent of the decedent's contribution, the payments made by the employer under an unqualified pension plan, are to be taken into account. However, under an approved trust, pension, or retirement plan the employer's contributions are not to be considered as having been made by the decedent.

For values which are included in the gross estate, the House and your committee's bill provide an additional exclusion (income in respect of a decedent) when the survivor reports the income, equal to the estate tax attributable to the income element of the survivorship feature which has accrued since the annuity was purchased.

(2) Changes made by committee

Your committee adopted amendments clarifying the House bill so that annuities provided under an employee's trust (or under a contract purchased by an employee's trust) will be excluded from the gross estate if the plan is terminated prior to the decedent's separation from employment. If an annuity is attributable partially to contributions by the decedent and partially to contributions by the employer, the exclusion is limited to that part of the value of the annuity in proportion to the part of the total contributions made by the employer.

Subsection (c) was made applicable to all decedents dying after December 31, 1953.

F. Proceeds of Life Insurance (sec. 2042)

(1) House changes accepted by committee

The proceeds of life insurance on a decedent are subjected to tax in his estate under present law if the policy is payable to the executor, if the decedent paid the premiums on the policy (in this case includible in proportion to the amount paid), or if the decedent possessed any elements of ownership in the policy at date of death.

No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified.

The House and your committee's bill retains the present rule including life-insurance proceeds in the decedent's estate if the policy is owned by him or payable to his executor, but the premium test has been removed. To place life-insurance policies in an analogous position to other property, however, it is necessary to make the 5-percent reversionary interest rule, applicable to other property, also applicable to life insurance.

It is estimated that the change made by your committee in this provision will reduce revenues by about $25 million in the fiscal year 1955.

(2) Changes made by committee

None.

G. Expenses, Indebtedness, and Taxes (sec. 2053)

(1) House changes accepted by committee

Funeral expenses, administration expenses, claims against the estate and unpaid mortgages are deductible in computing the taxable estate under present law. However, this deduction is limited to those expenses allowable by the laws of the jurisdiction under which the estate is being administered and cannot exceed the value of the property included in the gross estate subject to claims, that is, the probate estate. Thus, if the decedent has placed most of his assets in a trust (not includible in his probate estate) funeral and other expenses actually paid by beneficiaries or expenses of administering trust property paid out of the trust assets are not allowed as a deduction to the extent they exceed the value of the property in the probate estate.

These arbitrary distinctions have been removed under the House and your committee's bill. Expenses incurred in connection with property subjected to the estate tax, although not in the probate estate, are to be allowed as deductions, if the expenses are of the type which would be allowed as deductions if the property were in the probate estate and they are actually paid within 1 year of the decedent's death.

In addition, expenses in connection with property subject to claims are to be allowed without regard to the total value of the probate estate if they are paid within the period provided for the assessment of the estate tax.

(2) Changes made by committee

None.

H. Transfers for Public, Charitable, and Religious Uses (sec. 2055)

(1) House changes

None.

(2) Changes made by committee

Your committee inserted a new provision which provides that bequests to veterans' organizations organized under an act of Congress will be deductible for estate-tax purposes. Gifts to these organizations are presently exempt from the gift tax and this provision in the estate tax will encourage bequests to those organizations devoted to promoting the welfare of the veterans, including the American Legion, the Disabled American Veterans, the Veterans of Foreign Wars, AMVETS, and the United Spanish-American War Veterans.

I. Marital Deduction (sec. 2056)

(1) House changes accepted by committee

A marital deduction is allowed in computing the taxable estate under present law for the value of property passing from one spouse to the other, if the surviving spouse has a right to the income from all of the property and has a general power of appointment over all of it. However, present law requires in such cases that the property be placed in "trust" and because of doubt under the law of the various States as to what constitutes a "trust" it is not clear when a legal life estate will qualify as a trust. Nor is it clear where property is placed in trust and the surviving spouse has an income interest in and power of appointment over part of the property, when the interests given the surviving spouse constitute a transfer in trust qualifying for the marital deduction.

The House and your committee's bill make it clear that property in a legal life estate as well as property in trust qualifies for the marital deduction and that a right to income plus a general power of appointment over only an undivided part of the property will qualify that part of the property for the marital deduction. Conforming changes have been made for life insurance or annuity payments where the surviving spouse has a power of appointment.

(2) Changes made by committee

Your committee rejected a special provision added by the House that allowed widows' allowances to qualify for the marital deduction to the extent paid within 1 year of the decedent's death. Under present law many widows' allowances qualify for the marital deduction without regard to the time of payment. It is believed that the House bill might raise some question as to the treatment under the marital deduction of these widows' allowances to the extent not received within 1 year of the decedent's death.

Your committee also made technical changes in this provision.

J. Stocks Situated in the United States (sec. 2104)

(1) House changes accepted by committee

Under present law stock held by nonresident aliens is treated as property situated in the United States if it is stock of a domestic corporation regardless of where the certificates are located, and if it is stock of a foreign corporation, if the certificates are located in the United States.

Under both versions of the bill only the first of these rules is retained: Stock is to be deemed to be situated in the United States only where it is stock in a domestic corporation.

This rule conforms to the tax conventions the United States has entered into with many countries and removes any deterrent to the use of United States bank and trust companies as depositories.

(2) Changes made by committee

None.

K. Members of the Armed Forces Dying as a Result of Service in a Combat Zone (sec. 2201)

(1) House changes accepted by committee

Present law exempts from the additional estate tax members of the Armed Forces dying in a combat zone, or dying from wounds or disease incurred while in a combat zone. However, this exemption applies only to those dying before January 1, 1955.

The two bills extend this exemption from the additional estate tax to cover any period in which persons generally are subject to induction under the Universal Military Training and Service Act. This change is similar to those previously described in the case of the income tax.

(2) Changes made by committee

None.

XXXIV. Gift Tax

A number of substantive changes in the House bill have been made in the gift tax provisions but the rate of tax is left unchanged.

A. Nonresident Aliens (sec. 2501)

(1) House changes accepted by committee

Present law applies the gift tax to all gifts made by citizens or residents of the United States. In the case of nonresident aliens the tax is imposed on all gifts of property within the United States.

The tax on gifts of nonresident aliens is easily avoided if the donor merely moves the property from the United States to a foreign country and makes the gift there. Thus, the chief effect of imposing the gift tax with respect to gifts of intangible property by nonresident aliens has been to deny United States financial institutions business as depositories for property which nonresident aliens can keep outside the United States if they intend to make gifts. Moreover, once the property is removed from the United States it is not returned since the donees fear that bringing property back to the United States would result in the imposition of a gift tax.

The bill imposes a gift tax with respect to all gifts made by citizens or residents of the United States wherever the property is situated. In the case of nonresident aliens who are engaged in business in the United States tax is imposed with respect to gifts of property situated in the United States. With respect to all other nonresident aliens the tax is imposed only with respect to tangible property situated in the United States.

(2) Changes made by committee

Your committee accepted the substantive changes made in the House bill but made certain clerical changes in order to achieve greater clarity.

B. Taxable Gifts (sec. 2503)

(1) House changes accepted by committee

Gifts to minors are often hindered by the fact that it is not clear how such a gift can be made in trust or through a guardian for a minor's benefit other than as a future interest, and for future interests the $3,000 exclusion is not available. Doubt arises as to whether a gift in trust for a minor can be a present interest since the child does not presently have complete control over the property. Where a child's guardian who has control over gifts to a child, is personally responsible for the support of a child, since he must provide for the current needs of the child, it would appear that a valid gift could only be for a child's future benefit.

The House and your committee's bill provides that gifts to minors will not be considered gifts of future interests if the income and property can be spent by or for the child prior to his attaining age 21 and if not so spent passes to the child when he reaches age 21 (or to his estate if he dies prior to age 21). Your committee accepted this provision in the House bill with certain technical changes to promote clarity.

(2) Changes made by committee

Present law provides an exclusion for the first $3,000 of gifts by a donor to a donee in a calendar year unless the gifts are gifts of future interest. Sometimes a present interest in property, such as a life estate, is coupled with a future interest, such as the power of a trustee to terminate a trust and make immediate distribution to the life tenant. Under present law the life estate might be held to have no value since the future interest could result in its immediate termination although such termination would increase rather than diminish the value of the gift to the donee. Therefore, the House and your committee have added a new provision that will allow the value of the present interest to be computed without regard to the effect of the power upon it if the power can only be exercised to increase the donee's interest in the property.

C. Revaluation of Gifts for Prior Years (sec. 2504)

(1) House changes accepted by committee

Due to the cumulative nature of the gift tax and the progression in gift-tax rates, the tax liability for gifts in a particular year is dependent on the correct valuation of gifts in prior years. Therefore, a taxpayer's gift tax liability for 1953, for example, might be dependent on whether the valuation of a gift made in 1935 is larger, smaller, or the same as previously reported, although the statute of limitations has run on the tax paid on the 1935 transfer.

It is believed that once the value of a gift has been accepted for purposes of the tax by both the Government and the taxpayer, this value should be acceptable to both in measuring the tax to be applied to subsequent gifts. For that reason the bill provides that the value of a gift as reported on a taxable gift tax return for a prior year is to be conclusive as to the value of the gift (after the statute of limitations has run) in determining the tax rate to be applied to subsequent gifts. This substantially increases certainty in the gift tax area.

D. Tenancies by the Entirety (sec. 2515)

(1) House changes accepted by committee

Under present law the creation of a tenancy by the entirety may result in a gift from one spouse to the other at the time the tenancy is created. Moreover, the termination of the tenancy may also constitute a gift unless the proceeds are divided between the husband and wife. Frequently, real property is held in a tenancy by the entirety to insure the right of survivorship in the surviving spouse. Many couples who elect this method of buying a home have no intention of making a gift at the time of the creation of the tenancy by the entirety or any knowledge that they are considered as having done so.

The House and your committee's bill provides that unless the spouse who furnishes the major part of the consideration for the property elects otherwise, a transfer of real property to a tenancy by the entirety will not be regarded as a gift at that time. However, when such a tenancy is terminated a gift is considered as occurring at that time to the extent the proceeds are returned to the husband and wife other than in proportion to the consideration furnished by each spouse.

(2) Changes made by committee

Many States do not recognize a tenancy by the entirety but do allow husband and wife to hold property as joint tenants with right of survivorship. In order to make the benefits of this section applicable to all taxpayers, your committee has expanded the House provision to include joint tenancies in real property between husband and wife with right of survivorship.

E. Property Settlements Incident to Divorce (sec. 2516)

(1) House changes accepted by committee

Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift-tax status under present law of settlements not incorporated in the decree of divorce is uncertain.

Both versions of the bill provide that property settlements involving transfers between spouses are not to constitute taxable gifts if followed by a divorce within a reasonable length of time.

(1) House changes accepted by committee

None.

F. Marital Deduction (sec. 2523)

(1) House changes accepted by committee

To correlate the marital deduction under the gift tax with the changes made by the committee in the marital deduction under the estate tax, both versions of the bill make it clear that transfers to a spouse of a legal life estate in property coupled with a general power of appointment are eligible for the marital deduction under the gift tax.

(2) Changes made by committee

None.

XXXV. EXCISE TAXES ON ALCOHOLIC BEVERAGES AND TOBACCO (CHS. 50, 51)

The provisions of present law relating to alcoholic beverages and tobacco have been substantially, revised, 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 will substantially reduce the compliance costs of the industries concerned and permit more efficient administration. Your committee has made few substantive changes in the House bill.

(1) House changes accepted by committee

A. Use of returns for payment of tax.—In the case of the excises on both alcoholic beverages and tobacco products, the House and your committee's bill provide that the taxes are to be paid by returns rather than by the present system of the purchase of tax stamps. However, the bills provide that the Secretary of the Treasury shall decide when after January 1, 1955, the return system shall be instituted. 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 stated 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. The contemplated change to a delayed-return system is recognition of the burden of the present system on producers.

B. Penalties.—Under present law the provisions imposing penalties for violation of the law with respect to the taxes on alcoholic beverages and tobacco products often provide for minimum as well as maximum fines and jail sentences. The mandatory minimum requirements have been deleted in the two bills because it has been found that they have interfered with the effective administration of justice in such violations. In certain cases, defendants have received suspended sentences because the courts felt the minimum requirements were excessive in view of the circumstances. With the removal of the minimum penalties, the courts will have greater freedom to fix sentences according to the circumstances as they see them.

C. Distilled spirits.—Due to a lack of time the revision of the distilled-spirits provisions was more limited than in the case of the provisions relating to the other alcoholic beverages and tobacco products. An Alcohol Tax Survey Committee of the Treasury Department is now working with a committee of the distilled-spirits industry to consider further changes for submission to the next Congress. Nevertheless, a number of substantive changes are made by the two bills. The more important changes, other than those already mentioned, are listed below.

(*a*) Authorization is provided for voluntary destruction of distilled spirits prior to withdrawal from bond. Present law provides for the collection of tax on distilled spirits voluntarily destroyed unless such spirits are unfit for beverage purposes. This provision works a hardship on the industry, since spirits, although not considered unfit for use as a beverage, may still be generally unacceptable to consumers and thus in fact commercially worthless.

(*b*) Distilleries are authorized to conduct other businesses, except specifically prohibited businesses, on distillery premises, when it is found by the Secretary or his delegate that such operations will not jeopardize the revenue. Currently, only operations connected with the production of distilled spirits may be conducted on distillery premises. One example of a type of business which might be authorized is the manufacture of antibiotic drugs which requires large-scale fermenting equipment of the same character as that used in a distillery.

(*c*) The bills remove the requirement of present law that all stills, for whatever purpose intended (except stills for refining petroleum), be registered. Registration is to be required only of stills intended to be used for the distillation, redistillation, or recovery of distilled spirits.

Under present law many thousands of stills used for distilling water, or in the preparation of drugs, chemicals, or for recovering cleaning fluids are required to be registered. This has placed a major burden both upon the industries using such stills and the Government. The general requirement for registration of all stills has not materially aided the enforcement of the revenue laws relating to liquors.

D. Fermented malt beverages.—The provisions of these bills relating to fermented malt beverages represent a substantial revision of present law. Many specific details have been modified to permit greater adaptability to specific circumstances and to permit greater freedom of action by brewers. The provisions listed below represent the more important changes made.

(*a*) Brewers are authorized to use their premises for producing and bottling soft drinks and for such other businesses as the Secretary may find will not jeopardize the revenue. Breweries which on June 26, 1936, were bottling soft drinks are allowed to carry on such business under present law. Many small brewers have excess bottling and canning capacity which could be utilized for producing soft drinks and in this manner make their operations more economical.

(*b*) The bills provide for the refund or credit of tax paid on beer belonging to a brewer if it is returned to the brewery for reconditioning, for use as materials, or destroyed under required supervision. Provision also is made for credit or refund of tax paid if beer belonging to a brewer is lost by casualty (other than by theft). No claim for casualty loss will be allowed, however, if the brewer was indemnified by insurance or otherwise.

Under present law, there is no provision for such credits or refunds. Where such loss or destruction takes place prior to passage of title by the brewer, he is now charged tax on production from which he receives no benefit. This change will make the basis of brewers' tax payments more nearly comparable to those of most other excise taxpayers.

(*c*) A brewer owning two or more breweries is authorized to transfer beer without payment of tax from one brewery to another. Existing law does not permit such transfers, but comparable tax-free transfers under bond are permitted for wines and distilled spirits.

E. Wines.—Present laws relating to wines have been changed substantially to align them with modern production methods and practices and remove numerous unnecessary restrictions. Present wine laws are outmoded, and the industry has requested modernization. The major changes made in the wine laws by the two bills are listed below.

(*a*) Wineries are to be granted permission to carry on certain operations in wineries besides the making of wine, if these operations are conducted in a manner which will not jeopardize the revenue. This will permit wineries to be used for making fruit juice, jellies and jams, and thus permit more efficient utilization of the wine premises.

(*b*) A thorough revision of the definitions of wines, the methods of preparation permitted, and the required standards of quality is made in the bills. These changes have been made to bring the law in line with modern production practices and to provide for greater clarity as to permissible activities and standards. One of the most important changes is the provision permitting use of methods acceptable in "good commercial practice" to correct and stabilize wine. Present law prescribes that only "usual cellar treatment" may be used. This change in wording will make it possible to recognize new methods which may be developed in the future.

(*c*) The bills provide a new category of premise, the taxpaid wine bottling house, which will operate under Government supervision. Under present law the Government cannot supervise the bottling of taxpaid wine. This lack of control has led to administrative difficulties as well as to frauds on the revenue.

(*d*) Provision is made for the allowance of all losses of wine while in bond except losses by theft occurring because of negligence or collusion. No allowance will be permitted where the claimant is indemnified by insurance or otherwise. Allowance also is made for voluntary destruction of wine in bond. Under present law, all losses in bond are allowed purely at the discretion of the Commissioner. Under this rule, tax has been levied in all cases of loss by theft, and destruction without payment of tax has been permitted only for wine unfit for use as wine. These changes bring the wine provisions in line with those for distilled spirits lost or destroyed while in bond.

(*e*) The bills authorize the refund or credit of tax paid on unmerchantable sparkling or artificially carbonated wine which has been returned to a bonded premise. No such provision now exists. Where effervescent wines become unmarketable as sparkling wines, as in the case of loss of sparkle, the loss in value is substantial because of the much higher tax rates for effervescent wines than for still wines. This new provision is intended to give relief in such cases. The principle used here has long been in effect with respect to tobacco products where provision is made for redemption of stamps used on taxpaid products subsequently withdrawn from the market.

(*f*) The bills provide that the tax base for sparkling and artificially carbonated wines is to be a wine gallon instead of the present base of each one-half pint or fraction thereof in each container. The rates for these wines have been restated to make them the practical equivalent of the existing rates. For example, the rate on champagne or other sparkling wines has been changed from 17 cents on each half pint or fraction thereof in each bottle or other container to $3.40

per wine gallon. The rate per wine gallon is set at 20 times the rate per half pint because most such wine is bottled in fifths, and each fifth is taxed at 4 times the half-pint unit rate.

This change will establish a uniform taxable unit for all wines and avoid the present tax penalty on using bottles not containing an even multiple of half pints.

(*g*) The bills clarify the exemption from tax for hard ciders (usually sold during season by farmers at roadside stands) to provide that it applies when the cider is not preserved by any process or by the addition of any material and is not offered for sale as wine or a substitute for wine. Such cider was not taxable prior to 1936, but the amendment of the law in that year to refer specifically to "apple wine" raised some question as to whether hard ciders might be taxable. This revision will remove the uncertainty.

F. Tobacco products.—The new chapter relating to cigars, cigarettes, chewing and smoking tobacco, snuff and cigarette papers and tubes represents a complete revision of present law. Provisions which have no relevance to present-day business practices have been eliminated (such as references to peddlers), and for many detailed recordkeeping requirements there has been substituted a provision which permits required records to be specified by regulation. Other important changes made by the two bills are listed below.

(*a*) Detailed statutory provisions specifying the permitted sizes of packages and the exact wording of notices and labels to be put on packages have been removed. The revised law is intended to afford relief to the industry from present rigid requirements by giving authority to effect changes by regulation.

(*b*) The bills authorize credits or refunds to be made to the manufacturer for tax paid on articles lost by casualty (except by theft) while in his possession. Present law already allows the refund of tax on articles withdrawn from the market by the manufacturer. Several court decisions have interpreted "withdrawal from the market" to include loss by casualty (other than theft) while taxpaid articles are still in the possession of the manufacturer. This change will bring the law specifically in line with these court decisions.

(*c*) The bills provide that every person before commencing business as a manufacturer of tobacco products must obtain a permit to engage in such business. The permit may be refused if it is deemed that the applicant is unlikely to comply with the tobacco tax provisions. Once issued, permits may be suspended or revoked after hearing before proper authority.

These provisions are inserted in the law to provide an effective means of terminating operations by manufacturers and dealers who violate the law and regulations. At the present time, manufacturers and dealers must register before commencing business, but such registration has only informational value for there is no restrictive control connected with such registration.

(2) *Changes made by the committee*

A. Stamps to evidence compliance with law.—At the present time, the stamps purchased in payment of taxes on alcoholic beverages and tobacco are sold for their tax value. There is no charge for the stamps as such. However, in addition, the law requires strip stamps to be placed on individual bottles of distilled spirits to evidence payment of tax. These stamps cost producers 1 cent per bottle (one-fourth cent for bottles of less than one-half pint). In the fiscal year 1953, the Treasury Department collected $14.4 million from the sale of strip stamps.

In the House bill, the required use of strip stamps on distilled spirits containers was continued, along with the present charge for such stamps. In addition, the House bill provided that when the return system for liquor and tobacco taxes was instituted, the Secretary or his delegate might require stamps to be affixed to containers of beer and tobacco products to indicate compliance with the law. Such stamps were to be sold to manufacturers at a sum sufficient to defray the expense of preparing such stamps.

Your committee has retained the required use of strip stamps in the case of distilled spirits, and the option of the Secretary to require them in the case of beer and tobacco products, but has provided that in all cases the stamps shall be furnished to manufacturers without cost. Since the stamps are, or may be, required as a means of safeguarding the revenue, it is felt that producers should not be required to pay for them but that their cost should be part of the administrative expenses of Government. It should also be noted that the sale of strip stamps for beer and tobacco products would have had the effect of slightly raising the tax on these products, for there is no charge for the stamps now used beyond their tax value.

B. Classification of sake.—Your committee has continued the classification of sake and similar products as beer. The House bill would have reclassified them as wines. Since these products have been classified as beer for many years and are made in breweries, it is felt that they should continue to receive the benefit of existing treatment. Consumption of sake is very limited. As sake and similar products usually contain from 16 to 18 percent of alcohol, their classification as wines would have resulted in a wine tax of 67 cents per gallon. The tax on beer is about 29 cents a gallon.

C. Effective date for use of breweries for other operations.—The right of the Secretary to permit breweries to carry on other businesses has been made effective the day after the effective date of the act. Under the House bill, the effective date was January 1, 1955, the general effective date for this chapter. Since some breweries long have had the right to bottle soft drinks, it is felt that there is no reason to delay the equalization of opportunity provided by the bill.

XXXVI. Provisions Relating to Procedure and Administration

The House and your committee have made a comprehensive revision of the portion of the Internal Revenue Code relating to procedure and administration. The changes represent a substantial simplification of existing provisions. Administrative provisions presently scattered throughout the code have been brought together into a new subtitle. As a result of this reorganization it has been possible to combine a great number of provisions, shortening them and providing more uniform application for the various internal revenue taxes. The new provision relating to the time and place for paying any tax shown on a return, for example, represents the combination of 34 different provisions in the existing code presently scattered all the way from section 53 to section 3791. To a substantial degree the uniformity has been achieved by applying to all taxes the more detailed administrative and procedural rules presently applicable only to the income tax.

The new provisions relate generally to all internal revenue taxes imposed and, with the exception of those applying to the alcohol and tobacco taxes, only a few administrative provisions of special application have been left in the taxing subtitles. Many of the administrative and procedural provisions relating to the alcohol and tobacco taxes have not been brought into the general administrative subtitle because of their specialized character.

The 3 changes of most general application and interest—the changes in the time for filing returns, the changes made in the declaration system for individuals, and the establishment of a declaration system for corporations—are discussed in the first 3 sections below. Other changes of significance are described briefly in the remaining sections under their chapter headings in the new code.

A. Filing Date for Tax Returns (secs. 6072, 6073, 6074)

(1) House changes accepted by committee

The House and your committee's bill postpones from March 15 to April 15 the date for individuals using a calendar year to file their income tax returns. A similar 1-month postponement is provided for individual income taxpayers using a fiscal year.

It is believed that this change will greatly relieve the difficulties taxpayers now have in preparing their returns by the present filing date. This should also result in the filing of more carefully prepared returns and in addition should be beneficial to those who aid taxpayers in making out their returns.

This change in filing dates is effective for the 1954 tax liabilities of calendar year taxpayers which are reported for tax purposes in 1955. It is also effective for fiscal year taxpayers with respect to tax liabilities for years beginning after December 31, 1953, and ending after the date of enactment.

The change in the return date also involves the postponing from March 15 to April 15 of the filing date for the declaration of estimated tax (and the first payment of estimated tax). However, no changes were made in the case of the present June 15, September 15, and January 15 dates for amending declarations of estimated tax (and for the last three quarterly payments of estimated tax).

Under present law farmers are required to file their declarations of estimated tax by January 15 or, if they do not wish to file their declarations by that time, file their final return by January 31. The House and your committee's bills have moved up this alternative filing date for final returns of farmers from January 31 to February 15. They also extend the definition of farming to include oyster farming.

No change is made in the March 15 filing date for corporations except in the case of tax-exempt cooperatives. The filing date for the returns of these cooperatives is postponed until September 15 (following the year of tax liability) to coincide with their last date for declaring patronage dividends with respect to the prior year's business.

(2) Changes made by committee

Your committee's bill advances from January 15 to January 31 the date by which an individual (other than a farmer) must file a final return if he wishes to forego a final amended declaration and installment payment of estimated tax on January 15. It also advances from March 15 to April 15 the date for filing a gift tax return.

B. Declarations of Estimated Tax by Individuals (*secs. 6015, 6073, 6153, 6654*)

(*1*) *House changes accepted by committee*

Under present law individuals whose tax liabilities are not substantially discharged by withholding are required to file declarations of estimated tax and to pay on a quarterly basis the amount by which their estimated tax exceeds that which will be withheld during the course of the taxable year. A declaration of estimated tax must be filed by an individual whose income is primarily from wages or salaries if this income is expected to be more than $4,500 plus $600 for each exemption. Individuals with over $100 of income from sources not subject to withholding are required to file declarations of estimated tax if they expect their gross income to exceed $600.

These requirements have resulted in the filing of over three-quarters of a million declarations where the individuals have no payments to make with the declaration, and several hundred thousand where the payments are very small. This unnecessary filing results from the fact that the present requirements are geared to match the estimated tax with final tax liability, irrespective of how small the amount of tax due in excess of that withheld. Moreover, the filing requirements do not make adequate allowance for the standard deduction in the case of wage and salary recipients or for personal exemptions in the case of other taxpayers.

Additional charges are imposed under the present law for failure to file a declaration or make a payment of the estimated tax or for substantial underestimates of tax liability. These charges may be severe. For failure to file a declaration or to pay an installment of the estimated tax, the total charge may be as high as 9 percent of the unpaid installment. For a substantial underestimate of tax, that is, an estimated tax which is less than 80 percent of the actual tax liability for the year (66⅔ percent in the case of farmers), a charge of 6 percent of the amount by which the final tax liability exceeds the estimated tax may be imposed. This charge and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 percent of the estimated tax due.

These charges are not only severe but also complex. Three different calculations are necessary to determine the charges imposed for failure to comply with estimated tax provisions.

The present system of additional charges also encourages deliberate underestimates because no charge is made where an individual substantially underestimates his tax but corrects his estimate by January 15 of the following year. This discriminates against both the taxpayer who estimates his tax correctly but fails to make his installment payments and the taxpayer who pays much of his tax during the year but fails to meet the 80 percent test by January 15.

Finally, the present system of additional charges is unfair to taxpayers who expect to receive the greater part of their income in the latter part of the year. Such taxpayers may be forced to choose between deliberately understating their tax at the time the first declaration is filed, or borrowing or temporarily reducing their capital in order to pay taxes on income which they have not yet received.

To correct these deficiencies in the provisions relating to estimated tax, the House and your committee's bill provide for changes in the filing requirements and in the system of additional charges.

For an individual with no more than $100 of gross income from sources other than wages or salary, a declaration is to be required only if gross income is expected to be $5,000 or more. However, no declaration will be required by a married person if his gross income, combined with that of his spouse, is expected to be less than $10,000. The $10,000 requirement also applies to heads of households.

For individuals who expect to receive more than $100 of income not subject to withholding, a declaration will be required only if gross income from other sources is expected to be more than $600 per exemption plus $400. These revised filing requirements will substantially reduce the number of declarations involving little or no tax in excess of the amount withheld, and will thus produce savings both for taxpayers and the Internal Revenue Service.

In place of the present complicated and severe system of additional charges, the House and your committee's bill provide a uniform charge of 6 percent per annum for underestimates and unpaid installments of estimated tax. In general, this charge is to be imposed where the installment payment made by the taxpayer is less than 70 percent (66⅔ for farmers) of the quarterly installment due on the basis of the tax shown on the final return (less the amount of tax withheld). The 6 percent per annum charge is to be based on the amount of this difference.

However, in order to make allowance for the fact that many taxpayers are uncertain during the early part of the year as to what their income and tax will be over the year, no charge will be imposed, even if the installment payment is less than 70 percent of the quarterly installment due, if the amount paid as estimated tax is (1) the same as the previous year's tax or (2) the tax for the previous year as it would have been if the rates and personal exemptions applicable to the current year had been used.

In addition, the taxpayer will be able to avoid an additional charge if his total payments on or before any installment date are at least 70 percent of an estimated tax computed by projecting to the end of the year the income received from the beginning of the year up to the month in which an installment is due. This provision is designed to correct the deficiency in the present system of additional charges for taxpayers who expect to receive the greater part of their income in the latter part of the year.

(*2*) *Changes made by committee*

Your committee's bill also provides that no additional charge will be imposed where the amount paid as an installment of estimated tax (together with previous installment payments) is equal to 90 percent of the tax computed, at the rates applicable for the taxable year, on the basis of the actual taxable income for the months in the taxable year ending before the month in which the installment is required to be paid. The provision in the House bill that the taxpayer may avoid additional charges where his installment payment of estimated tax is based on annualization of his income up to the date of the installment fails to afford relief where the taxpayer receives a substantial amount of income during the early part of the year and expects to receive substantially less income during the remainder of the year. Your committee's provision is designed to prevent the imposition of possibly substantial additional charges in such cases.

C. Declarations of Estimated Tax and Tax Payment Schedule for Corporations (secs. 6016, 6074, 6154, 6655)

(1) House changes accepted by committee

The Revenue Act of 1950 accelerated corporation tax payments from 4 quarterly installments spread over the 12 months following the taxable year to two 50-percent installments, payable in the third and sixth month after the close of the taxable year. The transition to a 2-installment system was accomplished over a 5-year period beginning with 1950 and ending with 1954 tax liabilities. Calendar year corporations, for example, will pay 45 percent of their 1953 tax liabilities in March of 1954, 45 percent in June, and 5 percent each in September and December. Their 1954 tax liabilities will be paid half in March and half in June of 1955.

The present 2-installment system lumps substantially all tax payments of calendar-year corporations within the 90-day period between March 15 and June 15. Since corporate taxes account for almost 30 percent of the Government's total receipts, the lumping of the flow of corporate-tax payments to the Treasury aggravates the effect of Treasury operations on the money markets. It increases the problems of managing the public debt and makes it more difficult for corporations to manage their own financing.

Moreover, many large corporations in effect make advance payments of their income taxes by the purchase of short-term Government securities. Although this funding of tax payments serves to make funds available to the Government, it involves additional interest payments by the Government and increases the problems of managing the short-term debt.

To remedy this situation, the House and your committee's bill provide a system of declarations of estimated tax from the larger corporations which restores the four quarterly installment system and reduces the time the corporation is given for the payment of its tax. This is accomplished in a way which will afford the business community ample opportunity to adjust to the new system and will work no hardship on seasonal businesses or businesses with limited liquid funds.

The bills require corporations to file a declaration of estimated tax and to make a partial payment on account of current tax liability by the middle of the ninth month of the year of the tax liability and another by the middle of the last month of the same year. When this plan is fully effective, calendar-year corporations will pay one-fourth of their estimated tax on September 15 of the year of the tax liability and another quarter on December 15 of the same year. A quarter will be paid on March 15 of the year following the taxable year and the final payment on June 15 of that year.

To facilitate the transition to the new system, the bills make provision for a gradual shift to the new system over a 5-year period, starting in 1955. In the case of a calendar-year corporation 5 percent of the estimated 1955 liability will become due on September 15, 1955; another 5 percent will be due in December, and about 45 percent of the actual tax will be payable in the following March and another 45 percent in June. For the 1956 liability, the September and December payments will be about 10 percent and the following March and June payments about 40 percent each. The September and December payments will continue to increase each year until they both reach 25 percent of the estimated tax for 1959 liabilities, when both the March and June payments will have been reduced to about 25 percent of the actual tax. In 1960, and in subsequent years, corporation income taxes will be due in four quarterly installments, extending from the middle of the ninth month of the current year to the middle of the sixth month of the following year. The schedule of corporate tax payments during the past 5 years and the schedule under the House bill for the next 5 years is as follows:

Payment schedule for corporation income tax under prevailing law, 1949–54, and proposal, 1955–59

[Calendar year corporations; showing percent of tax liability due in each installment]

Income year	Income year		Following year				Total
	September	December	March	June	September	December	
1949			25	25	25	25	100
1950			30	30	20	20	100
1951			35	35	15	15	100
1952			40	40	10	10	100
1953			45	45	5	5	100
1954			50	50	0	0	100
1955 [1]	5	5	45	45			100
1956 [1]	10	10	40	40			100
1957 [1]	15	15	35	35			100
1958 [1]	20	20	30	30			100
1959 [1]	25	25	25	25			100

[1] Applicable to tax liability, in excess of $50,000 under the House bill and $100,000 under your committee's bill.

The House bill exempts from the required declaration of estimated tax and the new tax-payment schedule corporations whose yearly tax liability cannot reasonably be expected to exceed $50,000. Moreover it limits the current payment requirements to that portion of the tax liability in excess of $50,000. This exemption, which is designed to restrict the application of the new system to a comparatively large group of corporations, has been increased by your committee. The change is described below.

In the case of calendar-year corporations, which constitute more than two-thirds of the total, the effect of this declaration system is to shift tax collections from the second to the first half of the Government's fiscal year. This will have no effect on the Government's total tax collections during any fiscal year.

In the case of some fiscal-year corporations, however, the speedup will have the effect of shifting payments to an earlier fiscal year of the Government. A corporation whose fiscal year ends in June, for example, now makes its first payment in September. Under the new declaration system it will make its first payment the preceding March and its second payment in June. This will shift half of its annual tax liability to an earlier fiscal year of the Government. A similar shift will occur in the case of corporations with fiscal years ending in April or May, and for corporations with fiscal years ending in January, February, March, July, August, or September, one quarter of their tax liability is shifted to an earlier fiscal year of the Government.

Because of the changes in the payments of the fiscal-year corporations it is estimated that there will be an annual increase in tax collections in the fiscal years 1956 through 1960 of approximately $150 million, assuming present tax rates. Although these additional collections represent funds which otherwise would have been received in subsequent fiscal years, there will be no corresponding reductions in receipts in subsequent years if corporate profits remain at current levels.

To facilitate compliance with these provisions, the bills prescribe for corporations the same additional charges prescribed by the House bill in the case of declarations of estimated tax by individuals. These charges are equal to 6 percent (per annum) of the amount of underpayment. However, the charge will not be imposed if the estimated tax upon the basis of which the installments are paid falls into any of the following categories:

(1) If it amounts to 70 percent of the tax (in excess of $50,000) shown on the final tax return;

(2) If it amounts to as much as the previous year's tax;

(3) If it is equal to what would have been last year's tax liability if current tax rates had been applicable, less $50,000, to previous year's income; or

(4) If it is at least equal to 70 percent of the tax (less $50,000) due on the basis of projecting to the end of the year the income received from the beginning of the year up to the date of the declaration or its amendment.

These exceptions to the additional charges for failure to comply with the provisions for declarations of estimated tax, together with the $50,000 exclusion, will prevent the hardships which might otherwise be imposed on corporations which are uncertain as to what their income during the taxable year will be or which expect to receive the greater part of their income toward the close of the year.

These provisions relating to corporations' declarations of estimated tax will greatly assist in the management of the public debt with the least detriment to the money markets. Moreover, to the extent they speed up the collection of revenues, they will reduce the Government's short-term borrowing requirements.

(*2*) *Changes made by committee*

Your committee's bill extends the exemption from the required declaration of estimated tax, and from the new tax-payment schedule, to corporations whose yearly tax liability cannot reasonably be expected to exceed $100,000 and limits the current payment requirements and the provisions with respect to the 6 percent additional charge to that portion of the tax liability in excess of $100,000. With the $50,000 exemption in the House bill, the declaration system would leave unaffected about 390,000 corporations. It would affect, however, 35,000 corporations, accounting for about 90 percent of the corporate tax liabilities. Your committee's action will exempt an additional 15,000 corporations from the declaration and advance payment requirements. The remaining 20,000 corporations, however, account for about 85 percent of corporate income tax liabilities.

With respect to the additional charges imposed on corporations for failure to pay estimated income tax, your committee amended the House bill to provide that no additional charge will be imposed where the estimated tax installment is equal to or exceeds 70 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income either for the months in the taxable year ending before the month in which the installment is required to be paid, or the period ending 2 months before that month. This provision will substantially ease the compliance burdens for a number of corporations which, because of the difficulties in inventorying, would have inadequate time to prepare an estimate on the basis of the annualized income through the months ending before the month in which the installment is to be paid.

D. Information and Returns (ch. 61)

(1) House changes accepted by committee

(*a*) Present law requires the reporting of payments to another person (not a corporation) of $600 or more consisting of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other gains, profits, and income. The House omitted these provisions from the new code. It was stated that this was done because they have not been used extensively under existing law and because the requirements if interpreted literally would require the filing of these special informational returns by a vast number of individuals.

As indicated below, your committee modified the House action in this respect.

The House action did not affect the information returns presently required from corporations in the case of dividends and interest, nor reports presently required as to the collections of foreign items.

(*b*) The House and your committee's bill raise the minimum income tax return filing requirement from $600 of gross income to $1,200 of gross income for individuals over age 65.

(*c*) Married taxpayers are to be allowed under both the House and your committee's bill to file joint returns after having filed separate returns without first paying the tax shown on the separate returns. For example, if the separate return liability were $130 but the joint return liability only $18, a husband and wife could shift from separate to joint returns by paying only the $18. Under present law they would first have to pay the separate return liability of $130 and then claim a refund of $112.

(*d*) In the case of corporate returns, both versions of the bill require 1 officer to sign the return instead of 2 as at present. Moreover, any officer duly authorized by the company will be able to sign, rather than only certain specified officers as at present.

(*e*) The Secretary or his delegate is given the authority under both bills to grant an extension of time, up to 6 months, for the filing of any tax return. At present, this authority is limited to the income and certain other taxes.

Corporations are also given a 3-month automatic extension under the bills for filing their income-tax returns upon the filing of an appropriate form and the paying of the tax installment estimated to be due.

(*f*) The Secretary or his delegate is authorized by the two bills to allow the filing of returns in whole dollar amounts rather than showing on the return the exact cents.

(*2*) *Changes made by committee*

Your committee restored the provisions of existing law requiring information returns on certain payments to others of $600 or more a year. However, under your committee's bill these returns are to be required only with respect to payments made by businesses (either individual or corporate).

E. Time and Place for Paying Tax (ch. 62)

(*1*) *House changes accepted by committee*

A uniform rule is provided under both the House and your committee's bill permitting the Secretary or his delegate to extend the time for the payment of any tax for a period not in excess of 6 months (the 10-year period, however, is retained for the estate tax). This is present law for the income taxes, estimated income taxes, unemployment taxes, and gift tax, but in the case of many others there either is no provision for an extension of time or provision for only a 90-day extension.

(*2*) *Changes made by committee*

Your committee accepted the House provisions with only minor technical changes.

F. Assessment (ch. 63)

(*1*) *House changes accepted by committee*

Prior to the adoption of the reorganization plans, in the case of each of the approximately 90 million returns the law called for the making of assessment lists by the collectors, the transmission of these lists to Washington, and certification before assessment was accomplished. The effect of the reorganization plans on these requirements is not expressed in the 1939 Code.

Under the House and your committee's bill the assessment is to be made by recording the taxpayer's name, address, and tax liability. It is contemplated that this will be done by modern machine operations.

(*2*) *Changes made by committee*

The House changes were accepted with technical amendments.

G. Collection (ch. 64)

(*1*) *House changes accepted by committee*

(*a*) Under the House and your committee's bill while assessment may be made immediately when returns are filed early, payment before the due date for the return may not be demanded.

(*b*) The Secretary or his delegate is authorized by both bills to receive any check or money order in payment for taxes or stamps. Present law closely limits the type of check or money order which may be received for stamps.

(*c*) The House bill indicated the status of tax liens relative to other liens. The House bill provides that they are to be subordinate to prior valid liens of a bona fide mortgagee, pledgee, or purchaser but superior to these liens if such a person had knowledge of the tax lien. As is indicated below, your committee has made changes in this provision.

(*d*) In certain estate and gift tax situations priority of lien is provided by both bills for bona fide mortgagees and pledgees. The situation of bona fide purchases for full value is also improved in some cases.

(*e*) The law is clarified by both versions of the bill with respect to the right of distraint and levy (seizure) for the collection of tax liability. Also, in all cases of jeopardy the right is granted the Internal Revenue Service to seize property immediately after an unpaid notice and demand. Under present law there must be a 10-day waiting period in the case of income, estate, and gift taxes. However, your committee has added an additional provision in such cases.

(*f*) The right to levy on salaries due is extended by the two bills to permit the levying on salaries due Government employees in the same manner as is presently possible in the case of other employees.

(*g*) The list of household goods, etc., exempt from levy is modernized by both bills. Present law exempts "1 cow, 2 hogs, 5 sheep" (if the sheep are not worth more than $50), etc. The House bill exempts "necessary" wearing apparel and schoolbooks; fuel, provisions, personal effects, and furniture to the extent of $500; and necessary books and tools for the taxpayer's trade or profession up to $250. Your committee has accepted the House provision with the modifications indicated below.

Present law requires appraisals of the property exempt from levy by three "householders of the vicinity." The House and your committee's provision requires appraisal of the exempt property only if the taxpayer demands it, and then the appraisal is to be made by three disinterested individuals summoned by the officer making the seizure.

(*h*) The treatment provided for the sale of seized real and personal property is made uniform by the two bills.

Present law requires that in certain cases the place of the sale must be not more than 5 miles away from where the property was seized but this limit can be ignored on special order of the Commissioner. The new provisions require the sale to take place in the same county as the seizure except by order of the Secretary or his delegate.

The two bills permit more freedom in the methods of holding the sale of seized property in order to obtain the highest price possible to the benefit of both the taxpayer and Government. Public sale by sealed bids as well as by auction is permitted, the sale of items may be made singly or in groups, and down-payments by purchasers with the balance being paid in a month are permitted. An additional change made by your committee is noted below.

(*i*) New rules are provided by both bills for the sale of seized perishable goods to make such seizures feasible.

(*j*) New rules are provided by the two bills to insure valid certificates of title to purchasers of automobiles lawfully seized and sold by the Government.

(*k*) A new provision in both bills permits the releasing of seized property if the taxpayer makes satisfactory arrangements with the Internal Revenue Service for the payment of his tax, such as the payment in installments from part of his salary.

(2) Changes made by committee

Your committee adopted the collection provisions as passed by the House with the following major changes:

(*a*) It added a new section 6316 which at the discretion of the Secretary will allow the payment of taxes in currency of foreign countries.

(*b*) In the section dealing with liens for taxes the committee deleted the parenthetical reference to tenants by the entirety.

(*c*) In the section dealing with the validity of tax liens as against certain third parties, your committee deleted the subsection added by the House providing specific rules with respect to the validity of the tax lien without notice.

(*d*) With respect to property exempt from levy, your committee expanded the category of fuel, provisions, furniture, and personal effects (exempt up to $500) to include firearms and livestock.

(*e*) Your committee amended the provision relating to sale of seized property to provide that where property is seized under a jeopardy assessment which is then subject to review by the Tax Court, the Secretary (other than in cases such as that of perishable property) cannot sell the property, without consent of the taxpayer, pending the determination of the tax liability by the Tax Court. Furthermore, your committee's bill provides that where, because of jeopardy, property is seized before the expiration of the usual 10-day period after notice and demand, proceedings to sell such property may not be commenced until after such 10-day period.

H. Abatements, Credits, and Refunds (ch. 65)

(1) House changes accepted by committee

The rules now expressly provided in the code with respect to certain excises, that refunds will be made only if it can be shown that the taxes were not passed on to others (or were repaid to them) have been extended by the House and your committee's bill to include the cabaret tax, taxes on admissions and dues, and the tax on pistols and revolvers. Also, the rules permitting refunds of manufacturers' and retailers' excise taxes, with respect to price adjustments, are extended by the two bills to include such adjustments with respect to the excises on diesel fuel and pistols and revolvers.

(2) Changes made by committee

The House provisions were accepted by your committee with only technical changes.

I. Limitations (ch. 66)

(1) House changes accepted by committee

(*a*) The House bill extends to income, estate, and gift taxes the rule presently applicable to other taxes to the effect that there is no limit on the period of assessment and collection where there has been a willful attempt to defeat or evade tax (other than by the making of a false or fraudulent return). As is indicated below, your committee did not accept this change.

(*b*) The 3-year period of limitations for assessment or refund now applying in the case of the income, estate, and gift taxes is applied by both bills to excise taxes, which presently have a 4-year limitation period.

(*c*) The period of limitation for assessment by both bills is made 6 years instead of 5 in the case of the omission of 25 percent of gross income, and a similar rule is applied in the bill to the estate and gift taxes. However, under the bill this longer period is not to apply if disclosure of the nature and amount of omitted items is made on or with the tax return. (See below for committee modification.)

(*d*) A 6-year limitation for assessment is provided by the two bills for failure to include personal holding company data on the special schedule provided for this purpose in the corporation income tax return (no longer to be a separate return).

(*e*) As under present law there is to be no limitation on the time for assessment where no return is filed. However, if a "corporation" erroneously in good faith files a trust or partnership return, under both versions of the bill such return is to start the running of the statute of limitations.

As noted below, your committee also made another change in this provision.

(*f*) The income-tax rules, presently providing that the period for assessment is extended during bankruptcy or receivership proceedings, are to be made applicable under the House bill to all Federal taxes and to any Federal- or State-court proceeding. As noted below, your committee has modified this House provision.

(*g*) The 6-year period during which taxes may be collected after assessment is extended by the two bills for the time collection is delayed or hindered by reason of the taxpayer's property being outside the United States.

(*h*) The income-tax rule, that for limitation and interest purposes an early return is deemed filed on the last day for filing, is extended by the two bills to returns for all taxes.

(*i*) The period for criminal prosecution is extended by the House bill from 3 to 6 years for willful failure to pay any tax or to make a tax return, for making false statements, for intimidating United States officers, and for certain offenses by such officers. Under existing law, the period (3 or 6 years as the case may be) is extended for the period the individual involved is outside the judicial district where he committed the crime. The House bill provided that this extension would be applicable only for the period the taxpayer is outside the United States.

As is indicated below, your committee modified this provision substantially.

(*2*) *Changes made by committee*

In addition to technical changes, your committee made the following substantive changes to the House bill:

(*a*) In the case of the House provision which extends to income, estate, and gift taxes the rule presently applicable to other taxes to the effect that there is no limit on the period for assessment and collection where there has been a willful attempt to defeat or evade tax (other than by the making of a false return), your committee restored present law.

(*b*) In the case of the House provision relating to a 6-year, instead of a 3-year period of limitations for estate and gift taxes where an amount equal to more than 25 percent of the gross estate or total gifts is omitted from the return, your committee made it clear that the 6-year period is not to apply merely because of differences between the taxpayer and the Government as to the valuation of property.

(*c*) Your committee provided that information returns filed by organizations which had supposed they were tax exempt are to have the same effect as corporate income tax returns in starting the running of the statute of limitations.

(*d*) Your committee decided to make the House provision providing that the period of limitation is not to run during a period assets are in the control or custody of a court (and for 6 months thereafter) inapplicable in the case of probate and guardianship proceedings.

(*e*) In the case of claims for credits or refunds the House bill (and present law) provides that although a claim may be filed within 3 years from the date the return was filed, the amount to be refunded is limited to amounts paid within the 3 years preceding the date of the claim. Thus, in case of a late return, tentative tax paid on the due date might not be refunded. Your committee amended this provision by providing that the 3-year period for filing claims for credits or refunds runs from the due date for the return, not from the later actual filing date.

(*f*) The section relating to periods of limitation on criminal prosecutions was modified so as to restore existing law in the case of those offenses which have a 3-year period under existing law and a 6-year period under the House bill. Also, the change in existing law, so that (except in the case of a fugitive from justice) the statute would run while the taxpayer is outside the judicial district of his crime but within the United States, has been made applicable to certain pending cases under the 1939 Code. The cases to which this change is applicable are those in which the statute has more than 3 years to run after enactment of this bill. It is further provided that in any such case the Government will have at least 3 years after the enactment of this bill before the statute will be treated as having expired.

(*g*) The period of limitations for recovery of an erroneous refund by suit by the United States where it appears that part of the refund was induced by fraud or misrepresentation of a material fact is to remain at 5 years as under present law rather than being increased to 6 years as provided by the House bill.

J. Interest (ch. 67)

(1) House changes accepted by committee

(*a*) One simple rule is provided under both bills for interest charged or paid: It is to be 6 percent from the due date until the amount is paid (except that a 4-percent rate is retained in certain estate-tax cases) or from the date of overpayment until not more than 30 days before a refund is paid. This is to apply to all taxes except where payment of estate tax is deferred under certain circumstances, when the present 4-percent rate is to apply. However, no interest is to be paid on refunds made within 45 days after the due date of the returns. As is indicated below, your committee made one exception to this general rule.

(*b*) In the case of a net operating loss carryback the House and your committee's bill provide that interest on the deficiency for the year to which the loss is carried runs until the end of the loss year; interest on the refund is to begin at the end of the loss year (rather than when the claim is filed as at present).

(2) Changes made by committee

The House provisions were accepted by your committee with technical modifications and a substantive change to the effect that interest will not be charged for a period of 10 days or less where an amount is paid within 10 days after notice and demand.

K. Additions to Tax, Additional Amounts, and Assessable Penalties (ch. 68)

(1) House changes accepted by committee

(*a*) The additions to the tax (5 percent for negligence or willful disregard of regulations and 50 percent for fraud) are to be applied under both bills to deficiencies or underpayments and not to the whole tax, as is presently true in the case of the excise taxes. These additions, and also the addition of from 5 to 25 percent for failure to file a return on time, are to be applied to the net tax, i. e., the tax after credits for tax withheld, estimated tax paid, or other prepayments (see below for another modification made by your committee).

(*b*) A 50-percent addition to tax is provided by both bills for failure to pay a stamp tax, in lieu of the present 100-percent penalty.

(*c*) Where withheld or collected taxes are required to be deposited in approved depositories an amount equal to 1 percent per month is charged under both bills for any amount which should have been but was not so deposited, until it is deposited or until the tax intended to be deposited becomes payable.

(2) Changes made by committee

Your committee has provided that the 5-percent addition to tax for intentional disregard of rules or regulations is not to be imposed if the taxpayer disagrees with the rules or regulations in good faith and attaches a statement of his position to his return.

L. General Provisions Relating to Stamps (ch. 69)

(1) House changes accepted by committee

The House and your committee's bill combine in one chapter and simplify provisions relating to the issuance, use, cancellation, and redemption of stamps.

(2) Changes made by committee

None.

M. Jeopardy, Bankruptcy, and Receiverships (ch. 70)

(1) House changes accepted by committee

No substantive changes.

(2) Changes made by committee

Your committee changed the House bill and present law by providing that the collection of a jeopardy assessment may be stayed by filing a bond equal to (instead of double) the amount of the assessment.

Also, there was a change made in this chapter discussed under G–2–e above.

N. Transferees and Fiduciaries (ch. 71)

(1) House changes accepted by committee

Assessment of a transferee for a tax liability of the transferor is presently allowed under the income, estate, and gift taxes. The House and your committee's bill extends this to all other taxes but only (as to such taxes) if the transferee liability results from the liquidation or reorganization of a corporation or liquidation of a partnership.

(2) Changes made by committee

Only minor technical changes were made.

O. Crimes, Other Offenses, and Forfeitures (ch. 75)

(1) House changes accepted by committee

In this chapter all criminal offenses are brought together, as are all other offenses, and all provisions relating to forfeitures, except those relating to alcohol, tobacco, and certain firearms.

In general, uniform penalties are provided by the House bill instead of the varying penalties now provided for what in substance is the same offense, namely, the attempt to evade tax. For offenses of this type the penalties usually provided by the new provisions are fines of up to $10,000 or imprisonment up to 5 years, or both. Minimum penalties, however, are omitted. Except as indicated below your committee's bill provides the same rules as the House bill.

(*a*) A provision of the Criminal Code makes it an offense punishable by a $5,000 fine or 3 years' imprisonment, or both, to forcibly assault, resist, oppose, etc., any officer or employee acting under the internal-revenue laws. A similar, but amplified, provision of the House bill covers all cases where the officer is intimidated or injured; that is, where corruptly, by force or threat of force, directly or by communication, an attempt is made to impede the administration of the internal-revenue laws. The penalty in the case of all such attempts to interfere with administration of the internal-revenue laws under the House bill is to be a fine of not more than $10,000 or imprisonment for not more than 5 years, or both. Modifications of this provision made by your committee are noted below.

(*b*) More rigid restrictions have been imposed upon State officers by the House and your committee's bill to prevent divulging, or permitting to be seen, information obtained from the inspection of Federal tax returns. The restrictions imposed and the penalties for violation are similar to those already in effect for Federal officers.

The House and your committee provided more severe penalties for offenses by Government employees, making them correspond to the penalties imposed in the case of offenses by taxpayers. In addition, the offenses are more carefully defined.

(2) Changes made by committee

Your committee made the following substantive changes in the House provisions:

(*a*) Your committee provided that willful failures to file tax returns are to be considered misdemeanors (as under present law) instead of felonies (as under House bill). The maximum imprisonment, as under present law, will be 1 year (5 years under House bill) and the maximum fine $10,000 (same under present law and House bill).

(*b*) The maximum penalty for fraudulent and false statements under your committee's action is to be a fine of $5,000 ($10,000 under House bill) or imprisonment for 3 years (5 years under House bill), or both. (Under present law the maximum fines for these offenses vary from $10,000 to zero and the maximum imprisonment from 1 year to 5 years.)

(*c*) In the section relating to attempts to interfere with administration of internal-revenue laws, the offense "threats of force (including any threatening letter or communication)" is defined as threats of bodily harm to the officer or employee or a member of his family, is classed as a misdemeanor, and is subject to a maximum fine of $3,000 and maximum imprisonment of 1 year.

P. Judicial Proceedings (ch. 76)

(*1*) *House changes accepted by committee*

(*a*) In the case of civil actions for refund, it is provided in both the House and your committee's bill that when a taxpayer has sued for refund in a district court (or the Court of Claims) and the Government sends a notice of deficiency, the taxpayer is to be able to have all issues decided either in the district court (or Court of Claims) or in the Tax Court.

(*b*) Where a petitioner is a foreign corporation, trust, or estate, or a nonresident alien, it is provided in both bills that the Tax Court can order the foreign corporation, or its parent or subsidiary, or any other person under the control of the petitioner, to produce books and papers even if they are abroad. If the petitioner does not comply, the Tax Court is directed to strike out pleadings, dismiss the proceedings, or give judgment by default, as circumstances may indicate.

(*2*) *Changes made by committee*

(*a*) In the section relating to actions to enforce liens or to subject property to payment of tax, the rule as to the conclusive nature of the presumption that the assessment is valid for purposes of the adjudication was deleted by your committee. This rule was added by the House bill.

(*b*) Under your committee's action, retired Tax Court judges are to be paid the same amount as active judges (in lieu of their retirement allowance) for any periods when they are performing judicial duties.

(*c*) The clerk of the Tax Court, or his deputy, under committee action is specifically given the authority to administer oaths.

(*d*) Your committee provided that the Secretary of the Treasury is no longer to be responsible for providing the Tax Court with suitable rooms for its hearings.

(*e*) In the section dealing with petitions for review a party to a Tax Court proceeding is given 4 months after a decision is rendered to file a petition for review where such petition has already been filed by an adverse party. Your committee's action makes this 4-month period available to any party to the proceeding other than the original appellant.

(*f*) Your committee deleted the House provision relating to venue in criminal prosecutions. The House bill would have provided, among other things, that tax would be deemed to have been paid (and a return filed) in the judicial district where a taxpayer resides if the mails were used, or at the office of the internal revenue officer if delivered in any other manner.

Q. Miscellaneous Provisions (ch. 77)

(*1*) *House changes accepted by committee*

(*a*) Under the House and your committee's bill, if any claim, statement, or other document except a tax return is received after the day on which it is required to be filed it will nevertheless generally be considered as filed on time if the postmark shows a date on or before the due date. A registry receipt is to be prima facie evidence of delivery.

(*b*) The House and your committee's bill provide that the time for filing any document, or for performing any act, is to be extended to the day following Saturdays, Sundays, or legal holidays, as determined in the District of Columbia if the act is to be performed in Washington, or as determined under local law, if the act is to be performed in a district office or elsewhere. This presently is the rule with respect to petitions to the Tax Court.

(*2*) *Changes made by committee*

The House provisions in chapter 77 were accepted with only technical changes except that your committee restored the exemption from internal-revenue taxes in existing law for consular officers.

R. Definitions (*ch. 79*)

(*1*) *House changes accepted by committee*

No substantive changes.

(*2*) *Changes made by committee*

(*a*) In the case of the definition of an employee, your committee provided that in addition to the purposes under the House bill for which a full-time life-insurance salesman is considered an employee, he is to be considered an employee for purposes of sections 104, 105, and 106, relating to accident and health plans, and section 101 (b), relating to employee's death benefits.

(*b*) Your committee also provided that the term "possession" as used in the code, wherever appropriate, is to be considered as includng the Commonwealth of Puerto Rico.

XXXVII. Review of Refund Cases

(*1*) *House changes accepted by committee*

Under present law the Joint Committee on Internal Revenue Taxation reviews all internal revenue tax refund cases involving more than $200,000.

The House and your committee's bill provide that in the future the Joint Committee on Internal Revenue Taxation is to review all such refund cases involving more than $100,000.

(*2*) *Changes made by committee*

None.

DETAILED DISCUSSION OF THE TECHNICAL PROVISIONS OF THE BILL

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DETAILED DISCUSSION OF THE TECHNICAL PROVISIONS OF THE BILL

SUBTITLE A—INCOME TAXES

Chapter 1—Normal Taxes and Surtaxes

SUBCHAPTER A—DETERMINATION OF TAX LIABILITY

Part I—Tax on Individuals

Section 1. Tax imposed

Subsection (a) of this section corresponds to section 1 of the bill as passed by the House.

This subsection is derived from sections 11 and 12 of the Internal Revenue Code of 1939 and imposes a tax upon taxable income through a rate schedule which combines the normal and surtax on individuals (but providing that the tax consists of the normal tax and surtax). The credit provided by section 25 (a) of such code on account of partially exempt bond interest in the computation of normal tax net income, is reflected in section 35 of the bill, as a credit against tax. Therefore, the distinction between normal tax net income and surtax net income has been eliminated, and the tax is imposed upon "taxable income" as defined in section 63 of the bill. The use of the word "imposed" rather than "levied, collected, and paid," is only a modernization of language. Specific provisions regarding payment and collection of taxes are contained in the administrative sections of this bill.

Section 1 (c) of the bill also provides that the tax shall in no event exceed 87 percent of the taxable income for the taxable year. In cases where the alternative tax is imposed under section 1201 (b), the above limit shall apply to the partial tax only, in conformity with the holding in *Charles E. Merrill* v. *United States* (105 Fed. Supp. 379 (Ct. Cl., 1952)).

Subsection (b) provides a special computation of tax for an individual who qualifies as head of a household. This section is the same in substance as section 12 (c) of the 1939 Code both as respects the computation of tax and the conditions for qualification. Thus, the effect of the provision is that the tax imposed in the case of such a taxpayer will be an amount approximately equal to the tax as computed under section 1 (a) reduced by one-half of the amount by which such tax exceeds the tax that would be determined if the return of the taxpayer were a joint return to which section 2 is applicable. The provisions of section 12 (c) (3) containing the definition of head of household and the provisions of section 12 (c) (4), determination of status, are retained in this subsection.

Section 2. Tax in case of joint return of husband and wife

This section corresponds to section 12 (d) of the 1939 Code and provides that in the case of a joint return of husband and wife under section 6013, the tax imposed by section 1 (a) shall be twice the tax which would be imposed if the taxable income were cut in half.

This section also corresponds to section 2 (a) of the House bill insofar as that subsection is applicable to a joint return. The remainder of section 2 of the House bill, relating to the tax in the case of head of family, has been eliminated, and the provisions of existing law providing for partial income splitting in the case of a head of household have been substituted as section 1 (b) of the bill.

Section 3. Optional tax if adjusted gross income is less than $5,000

Section 3 corresponds to section 3 of the bill as passed by the House and to the provisions of section 400 of the 1939 Code (except that the term "alternative tax" in existing law has been changed to "optional tax" for purposes of clarity). The separate column in the tax table for heads of household which was eliminated in the House bill as a consequence of extending full income splitting to the head of a family, has been restored to accord with your committee's action in restoring existing law with respect to head of household.

Section 4. Rules for optional tax

This section, except for a clerical correction, is identical with section 4 of the bill as passed by the House.

This section provides certain rules for the optional tax imposed by section 3. These rules correspond to the provisions of sections 401, 402, 23 (aa) (4) and 404 of the 1939 Code, which are here combined for purposes of clarity. No substantive change is made.

Section 5. Cross references relating to tax on individuals

This section, like section 5 of the bill as passed by the House, contains cross references to other sections relating to (*a*) other rates of tax on individuals, and to (*b*) special limitations on tax. Two new cross references have been added.

PART II—TAX ON CORPORATIONS

Section 11. Tax imposed

This section corresponds to section 11 of the House bill.

This section, which imposes a tax on the net income of every corporation, corresponds to sections 13 and 15 of the 1939 Code except that the tax is imposed upon the "taxable income" of the corporation, the terms "normal-tax net income" and "surtax-net income" having been dropped in this revision.

This section also provides for the postponement for an additional year of the reduction of the normal tax from 30 to 25 percent. Thus, for taxable years beginning prior to April 1, 1955, the rate will be 30 percent, while for taxable years beginning after March 31, 1955, the rate will be 25 percent. The committee has made a technical amendment to make it clear that the 30 percent rate applies to taxable years beginning before April 1, 1954 and ending after March 31, 1954, without any reduction under section 108 (k) of the 1939 Code.

The provisions of section 15 (c) of the 1939 Code, relating to the disallowance of the surtax exemption of $25,000 in certain cases, are continued and included in section 1551.

Section 12. Cross-references relating to tax on corporations

This section, containing cross-references relating to the tax on corporations, makes appropriate changes in the references in the House bill to provisions relating to limitation on surtax exemption and to those involving additional tax in case of consolidated returns, to reflect changes in the section numbers of those provisions under your committee's amendments.

PART III—CHANGES IN RATES DURING A TAXABLE YEAR

Section 21. Effect of changes

This section is identical with section 21 of the bill as passed by the House. It supersedes section 108 of the 1939 Code. This section applies to all taxpayers, including individuals and corporations. It provides a general rule applicable in any case where the rate of tax imposed upon the taxpayer is increased or decreased or the tax is repealed, and where the taxable year includes the effective date of the change, except where that date is the first day of the taxable year.

Where this section is applicable, tentative taxes are to be computed by applying the rate for the period of the taxable year before the effective date of the change, and the rate for the period of the taxable year on or after such effective date to the taxable income for the entire taxable year. The tax imposed on the taxpayer is the sum of the proportion of each tentative tax so computed which the number of days in each period, that is, the period before the effective date and the period on and after the effective date, bears to the number of days in the entire taxable year.

If a tax is repealed, the repeal will be treated as a change of rate, and the rate for the period after the repeal for the purpose of computing the tentative tax in respect of that period will be zero. If the rate of tax is changed for taxable years "beginning after" or "ending after" a certain date, the following day is the effective date of the change, and if the rate is changed for taxable years "beginning on or after" a certain date, that date is the effective date of the change for the purposes of this section.

This section does not apply to a taxable year beginning before January 1, 1954, and ending after December 31, 1953. In the case of such a taxable year section 108 (j), relating to individuals, of the 1939 Code will continue to be applicable as if this subtitle of the new code had not been enacted.

PART IV—CREDITS AGAINST TAX

Section 31. Tax withheld on wages and special refunds creditable against income tax

This section is identical with section 31 of the bill as passed by the House. For simplicity, it consolidates sections 35 and 322 (a) (4) of the 1939 Code. No substantive change is made.

Section 32. Tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds

This section is identical with section 32 of the bill as passed by the House. It corresponds to section 32 of the 1939 Code and is identical in substance with that section.

Section 33. Taxes of foreign countries and possessions of the United States

This section is identical to section 33 of the House bill. It corresponds without change of substance to section 31 of the 1939 Code, providing a credit for foreign taxes.

A specific exception contained in section 31 with respect to the tax on self-employment income has been eliminated in this section as being unnecessary, since such tax will be imposed by chapter 2 of your committee's bill.

Section 34. Dividends received by individuals

This section corresponds to section 34 of the House bill. (There is no corresponding provision in the 1939 Code.) The section provides for a credit against the income tax of an individual of a percentage of the dividends received from domestic corporations which are included in gross income. The credit is applicable only to taxable years ending after July 31, 1954, and is limited to the following percentages of dividends received: 5 percent in the case of dividends received after July 31, 1954, and before August 1, 1955; and 10 percent in the case of dividends received after July 31, 1955.

Since the credit is applicable only with respect to dividends includible in gross income, effect must be given to the exclusion of dividends provided in section 116 of this bill.

The application of section 34 and section 116 may be illustrated by the following example:

Example.—A, an individual who makes his return on the basis of a calendar year, receives in the year 1954 the following dividends: $100 on March 1; $100 on June 1; $100 on September 1; and $100 on December 1. Fifty dollars of the dividend received by A on March 1, 1954, is excluded from gross income under section 116. The balance of the dividends received in 1954, amounting to $350, is includible in the gross income of A, and, subject to the section 34 (b) limitation, a credit of $10 is allowed under section 34 (5 percent of $200, the amount of the dividends received after July 31, 1954, that is, $100 received on September 1, 1954, and $100 received on December 1, 1954). If the same dividends are received on the same dates in the calendar year 1955, the entire $100 received on March 1 will be excluded under section 116. With respect to the remaining $300 included in gross income, subject to the section 34 (b) limitation the credit under section 34 will be $25 (5 percent of the dividends of $100 received on June 1, 1955, and 10 percent of the dividends (totaling $200) received on September 1 and December 1, 1955).

In cases where it may be essential to determine the actual time of receipt of the dividend the usual rules relating to constructive receipt and time of receipt of dividends will apply. For a cash basis taxpayer dividends are held to be received at the time of actual receipt rather than when declared or when mailed by the corporation (unless the taxpayer has exercised a choice to defer actual receipt in which case the rules of constructive receipt apply) (See *Sewell Avery* v. *Commissioner*, 292 U. S. 210). Similarly, where a stockbroker has purchased in his street name stock for customers, and receives on July 31, 1955, a dividend for such customers and transmits such dividend to them by check on August 2, 1955, the customer will be entitled to a credit of 5 percent. In such cases the broker, of course, will not take such dividends into income, nor receive a dividend credit with respect to such dividends, nor will he receive a deduction for any amount so paid to his customers.

Subsection (b) of section 34 limits the credit which otherwise would be allowed by subsection (a) to an amount which does not exceed the lesser of either (1) the amount of the tax imposed by chapter 1 (constituting the normal tax and surtax) for the taxable year reduced by the foreign tax credit allowable under section 33 or (2) 2 percent of taxable income for a taxable year ending before January 1, 1955, 7 percent of taxable income for a taxable year ending after December 31, 1954, and before January 1, 1956, and 10 percent of taxable income for a taxable year ending after December 31, 1955. Thus, if the taxable income of an individual for the calendar year 1954 was $4,600, his tax liability would be $996. If his foreign tax credit amounts to $600, the credit for dividends received would be the lesser of the two above-mentioned limitations, or $92 (i. e. 2 percent of $4,600). With the same set of facts, for a taxable year ending after December 31, 1954, and before January 1, 1956, the credit would be limited to $322 (i. e. 7 percent of $4,600). For a taxable year ending after December 31, 1955, the credit would be limited to $396 (i. e. $996 minus $600). The 10 percent limitation would not apply because it would result in a larger credit than would be allowed under the above-mentioned limitation.

The credit provided by this section is a credit against the taxes imposed by chapter 1, including the alternative tax. For this purpose the "tax imposed" does not include interest, penalties, and additions to the tax.

Subsections (c) and (d) of section 34 contain limitations and special rules for determining the types of distributions (and in certain cases, the portions thereof) which are treated as dividends for purposes of the credit. Thus, section 34 (c) provides that the credit shall not be allowed with respect to dividends from (1) insurance companies subject to tax under parts I and II of subchapter L (under the House bill, all dividends from insurance companies were excluded); (2) China Trade Act corporations (see sec. 941); (3) corporations exempt from tax under sections 501 (relating to charitable, etc., organizations) and 521 (relating to farmers' cooperative associations); and (4) corporations engaged in business in the United States possessions (and thereby permitted special tax treatment under sec. 931). Similarly, under section 34 (d) (1) (34 (d) (2) in the House bill), the so-called dividends paid by mutual savings banks and building and loan associations (and deductible from gross income by them under sec. 591) are ineligible for the credit. On the other hand, a distribution from any organization taxed as a corporation, such as a real estate trust, is (unless otherwise specifically excluded) eligible for the credit if the distribution is taxed as a dividend.

Patronage dividends paid by either exempt or taxable farm cooperatives do not constitute dividends within the meaning of section

34 (a). However, the credit is allowed for other dividends paid on capital stock by nonexempt cooperatives and capital stock dividends paid by certain building and loan associations.

In the case of a dividend by a regulated investment company, the credit under section 34 (a) is limited by relationship to the character of the underlying income in the hands of the investment company. Section 34 (d) (2) provides for this limitation by reference to section 854. The rule in substance is that, if the nondividend income of the investment company (that is, income which has not previously been subject to tax) consists of more than 25 percent of the total income of the company, the credit is allowed only with respect to an allocable portion of the dividend received by the investment company's shareholders (see sec. 854). The credit under section 34 does not apply to capital gain dividends paid by regulated investment companies.

Section 34 (d) (1) of the House bill, specifying the rules for computing the credit in the case of a distribution in kind, has been eliminated by your committee.

Subsection (e) provides that the credit shall not be available to a nonresident alien individual not engaged in trade or business in the United States with respect to whom a tax of 30 percent of gross income is imposed under section 871 (a).

Subsection (f) contains cross references to sections 642, 702, and 584, relating to estates and trusts, partnerships, and common trust funds, respectively. In general, the applicable principles are those applied in the case of the credit for partially tax-exempt interest under section 35. Thus, in the case of dividends received by an estate or trust, the credit is allowed to the estate or trust entity unless the dividends are distributable to a beneficiary and thus taxable to him, in which case the beneficiary is entitled to the credit. In the case of dividends received by a partnership, the credit is to be appropriately allocated among the partners.

Section 35. Partially tax-exempt interest received by individuals

This section, which is identical with section 35 of the House bill, provides for a credit against tax of an amount equal to 3 percent of the partially tax-exempt interest received by individuals. This credit is in lieu of the credit provided in section 25 (a) of the 1939 Code which in substance exempts such interest from the imposition of the 3-percent normal tax.

Subsection (a) provides a credit (against the tax imposed by subtitle A for the taxable year) of 3 percent of the amount that an individual receives as interest on obligations of either the United States, or corporations organized under act of Congress which are instrumentalities of the United States. The application of the credit is limited to cases where the taxpayer includes the interest so received in gross income and such interest is exempt from normal tax under the act authorizing the issuance of such obligations.

Subsection (b) limits the credit which would otherwise be allowed under subsection (a) to the lesser of either (1) the amount of tax imposed by chapter 1 reduced by the sum of the credits allowable for foreign taxes (under sec. 33) and for dividends received by an individual (under sec. 34) or (2) 3 percent of the taxable income for the taxable year.

Subsection (c) provides a cross-reference to section 171 (relating to amortizable bond premium).

Section 36. Credits not allowed to individuals paying optional tax or taking standard deduction

This section is identical with section 36 of the bill as passed by the House. It corresponds to section 23 (aa) (2) of the 1939 Code and provides that if an individual elects to pay the optional tax imposed by section 3 (supplement T tax under existing law) or if he elects to take the standard deduction, such individual shall not be allowed the credits provided in section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to taxes of foreign countries and possessions of the United States), and section 35 (relating to partially tax-exempt interest received by individuals).

However such an individual will be entitled to the benefits of the dividends received credit provided in section 34, and the credit for retirement income provided in section 38, unless his tax is computed by the district director pursuant to the provisions of section 6014, in which case such credits are not permitted.

Section 37. Retirement income

This section corresponds to section 38 of the House bill which is entirely new. Your committee has made several changes in the section, the principal one being the allowance of the credit to certain retired persons who have not attained the age of 65.

The House bill provides a limited exemption, by means of a tax credit, to all forms of retirement income in order to conform the tax treatment of all retired individuals to those who now receive tax-exempt social-security benefits and certain other retirement income.

Subsection (a) provides that a credit against tax shall be allowed a qualified retired individual in an amount equal to his retirement income (as limited by subsection (d)) multiplied by the first-bracket tax rate (which is now 20 percent). This credit shall be taken after certain other credits allowed under the code (i. e., the dividends received credit, the credit for foreign-income taxes, and the credit for partially tax-exempt interest); moreover, this credit cannot reduce the tax below zero. If the amount of the credit exceeds the tax otherwise due, no taxpayer shall be entitled to a refund by virtue of this section.

Your committee has made an amendment in subsection (a) to add the credit under section 32 (2) for tax withheld at source on tax-free covenant bonds to those credits which must be taken into consideration before the allowance of any credit for retirement income.

Under subsection (b), to qualify for this credit an individual must have received earned income before the beginning of the taxable year in excess of $600 in each of any 10 calendar years. The House bill referred to section 911 (b) (relating to earned income from sources without the United States) for a definition of earned income where the term means, generally, wages, salaries, professional fees, and compensation for personal services. A husband and wife may each qualify, and the section further provides that a widow or widower whose spouse had previously received such earned income shall be considered to have received such income.

Your committee has amended the section to provide in subsection (g) a definition of earned income for purposes of both subsections (b) and (d) (2). This definition provides that earned income shall have the same meaning assigned to it in section 911 (b), but it is made clear that earned income for purposes of this section does not include pensions and annuities.

In the House bill, subsection (c) defines retirement income as constituting income from pensions and annuities, interest, rents, and dividends, to the extent that each of these items of income is included in gross income under other provisions of the code. Under this latter qualification, for example, the first $50 of dividend income received by an individual in the calendar year 1954, excluded under section 116, would not be taken into account in computing retirement income, although all dividend income in excess of this amount would be included. Retirement income cannot include compensation for personal services rendered by the retired taxpayer during the taxable year.

Your committee has revised subsection (c) so as to permit a credit for the pensions received by certain individuals who have been retired under a public retirement system even though such individuals have not attained the age of 65. The House provision was applicable only in the case of individuals who had attained the age of 65 years before the end of the taxable year. Public retirement system is defined to mean a pension, annuity, retirement, or similar fund or system established by the United States, a State, a Territory, a possession of the United States, any political subdivision of any of the foregoing, or the District of Columbia; except that such term does not include a fund or system established by the United States for members of the Armed Forces of the United States. As a result of this change, teachers, firemen, policemen, or Federal employees, who are retired before reaching 65, may be entitled to a credit for their pensions, but not for such items of income as dividends, interest, or rents.

Subsection (d) provides an additional limitation on retirement income. The amount of retirement income (on which the credit is based) cannot exceed $1,200 less any amount received by the taxpayer as a pension or annuity under the Social Security Act, or the Railroad Retirement Act of 1935 or 1937, or otherwise excluded from gross income (e. g., certain veterans' pensions exempt from tax). Since these amounts are already excluded from income, and hence do not form a part of the base on which tax is computed, they are similarly excluded from the base on which the retirement income credit is computed. This reduction does not include, however, that part of any pension or annuity which is excluded from gross income because it represents, in effect, a return of capital or tax-free proceeds of a like nature. Accordingly, amounts excluded under section 72 (relating to annuities), section 101 (relating to life-insurance proceeds), section 402 (relating to taxability of beneficiary of employees' trust), and section 403 (relating to taxation of employees' annuities) are neither included in gross income for tax purposes nor do they serve to reduce the amount of retirement income for purposes of this section. Moreover, pensions in the nature of disability payments (e. g., under workmen's compensation acts or by reason of service in the Armed Forces), which are excluded from gross income under section 104 (relating to compensation for injuries or sickness), or section 105 (relating to amounts received under accident or health plans), also do not reduce the amount of retirement income for purposes of this section.

Retirement income is further reduced, dollar for dollar, by any amount of earned income in excess of $900 received by the retired individual in the taxable year. Accordingly, no retirement income credit may be claimed when the taxpayer's earned income equals or exceeds $2,100 in the taxable year.

To coordinate this section with the plan of the social-security system, your committee has amended subsection (d) to provide that if the individual has attained the age of 75, he is not required to reduce the amount of retirement income against which the credit is allowable by any earned income received during the year.

Your committee has provided in subsection (h) that the retirement income credit shall not be available to nonresident aliens.

The maximum credit available under this section is $240 in the case of a qualified individual. Its effect, generally, is to allow an unmarried individual (using the standard deduction, with no dependents) to receive a maximum amount of $2,666 of retirement income tax free; a married individual with no dependents, but with a wife to whom the section is inapplicable, a maximum of $4,000; and a married couple, each of whom qualifies and each of whom possesses retirement income, a maximum amount of $5,333.

Operation of this section may be illustrated by the following example:

Assume that an individual, 70 years of age, unmarried, using the standard deduction, has the following items of income in the calendar year 1954:

Dividend income received after July 31, 1954 (of which $50 is excluded from gross income under sec. 116)	$750
Pension under the Railroad Retirement Act of 1937 (entirely excluded from gross income)	600
Disability payments under a workmen's compensation act (entirely excluded from gross income under sec. 104)	400
Rental income	600
Earned at odd jobs	1, 300

First, the taxpayer must compute his tax before the credit, as follows:

Adjusted gross income	$2, 600. 00
Less standard deduction	260. 00
	2, 340. 00
Less personal deduction	1, 200. 00
Taxable income	1, 140. 00
	×20%
Tax before any credit	228. 00
Less dividends received credit under sec. 34	22. 80
Tax before retirement income credit	205. 20

Next, the taxpayer must compute his retirement income credit as follows:

Retirement income includes—	
Dividend income	$700
Rental income	600
Total retirement income	1, 300

But the limitations in subsection (d) provide that this amount must be reduced as follows:

Retirement income	$1,200
Less railroad-retirement pension	600
	600
Less earned income in excess of $900	400
	200
	×20%
Retirement income credit	40

Therefore, the correct tax is $205.20 less $40, or $165.20.

This section will not apply if the taxpayer elects to use the "short form" return and have the tax computed by the Commissioner under section 6014.

Section 38. Overpayments of tax

This section, which is identical with section 39 of the House bill, contains a cross-reference to section 6401, relating to credit against tax imposed by this subtitle for overpayments of tax.

SUBCHAPTER B—COMPUTATION OF TAXABLE INCOME

Part I—Definitions

Section 61. Gross income defined

This section corresponds to section 61 of the bill as passed by the House, except that one clarifying change has been made in section 61 (a) (13) in order to conform that section with section 702 (c), which provides that in any case where it is necessary to determine the gross income of a partner, such amount shall include his distributive share of the gross income of the partnership.

This section corresponds to section 22 (a) of the 1939 Code. While the language in existing section 22 (a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61 (a) is as broad in scope as section 22 (a).

Section 61 (a) provides that gross income includes "all income from whatever source derived." This definition is based upon the sixteenth amendment and the word "income" is used as in section 22 (a) in its constitutional sense. It is not intended to change the concept of income that obtains under section 22 (a). Therefore, although the section 22 (a) phrase "in whatever form paid" has been eliminated, statutory gross income will continue to include income realized in any form. Likewise, no change is effected by the elimination of the specific reference to compensation of the President and judges of courts of the United States, and the compensation of such individuals will continue to be taxed in the same manner as that of other taxpayers. In view of the fact that certain types of income are excluded from gross income by other sections of the income tax subtitle of the new code, section 61 (a) contains a clause excepting such income from the general definition of gross income.

After the general definition there has been included, for purposes of illustration, an enumeration of 15 of the more common items constituting gross income. It is made clear, however, that gross income is not limited to those items enumerated. Thus, an item not named specifically in paragraphs (1) through (15) of section 61 (a) will nevertheless constitute gross income if it falls within the general definition in section 61 (a).

Section 62. Adjusted gross income defined

This section corresponds to section 62 of the bill as passed by the House and to section 22 (n) of the 1939 Code.

Several clarifying changes have been added by your committee to conform to other provisions of the bill. Paragraph (1) corresponds to paragraph (1) of section 22 (n) of the Code of 1939. No substantive change is made.

Paragraph (2) sets out those deductions relating to certain trade or business expenses which are allowed to employees in computing their adjusted gross income. Subparagraph (2) (A) (reimbursed expenses) corresponds to paragraph (3) of section 22 (n) of the code of 1939 and subparagraph (2) (B) (expenses for travel away from home) corresponds to paragraph (2) of section 22 (n) of the code of 1939 except for a change in the title. No substantive changes are made in either of these subparagraphs. Two new deductions for employees have been added in paragraph (2); transportation expenses (added by subpar. (C)), and outside salesman's expenses (added by subpar. (D)).

Transportation expenses which are "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" and are not "personal, living or family expenses," are allowed as a deduction under subparagraph (C) from gross income in arriving at adjusted gross income. The term "transportation" is a narrower concept than "travel" and does not include meals and lodging but includes only the cost of transporting the employee from one place to another when he is not away from home in a travel status. If the employee is away from home in a travel status his expenses would be deductible under subparagraph (B). The transportation expenses under this subparagraph include not only the cost of transportation actually purchased by the taxpayer but also those expenses for transportation which he incurs in connection with his employment. For example, if an employee uses his own automobile to deliver merchandise locally for his employer, he will be able to deduct a pro rata share of the expenses of operating his automobile. Thus, he may deduct the cost of gasoline, oil, and similar expenses as well as depreciation attributable to such use, if he is not reimbursed for these expenses.

All expenses deductible under this section must, of course, be allowable expenses under part VI. Thus, transportation expenses do not include the expense of commuting to and from work. The latter expense constitutes a personal living expense and is never deductible.

Outside salesmen's expenses are provided for in subparagraph (D). Under this subparagraph expenses which are ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business as an "outside salesman" will be deductible in arriving at adjusted gross income. An "outside salesman" is an individual who is a full-time salesman who solicits business away from his employer's place of business. It does not include a salesman, a principal part of whose activities consist of service and delivery. Thus, a bread driver-salesman or a milk driver-salesman would not be included within the definition. Also not within the definition are salesmen whose principal activities consist of selling at the employer's place of business but who incidentally make outside calls and sales. (These salesmen are eligible, however, for a deduction of transportation expenses under subparagraph (C).) Outside salesmen who have incidental activities at the employer's place of business, such as writing up and transmitting orders, spending short periods at the employer's place of business to make or receive telephone calls, will still be eligible for the deduction allowed to "outside salesmen." A full-time "outside salesman" may deduct such expenses as those for telephone and telegraph, secretarial help, and entertainment.

Paragraph (3) corresponds to section 22 (n) (7) of the 1939 Code. Paragraph (4) corresponds to section 22 (n) (6) of the 1939 Code. Paragraph (5) corresponds to section 22 (n) (4) of the 1939 Code. Paragraph (6) corresponds to section 22 (n) (5) of the 1939 Code. No substantive change is made in these provisions.

The last sentence of section 62 contains a prohibition against double deductions for the same expenditures. This, of course, is the general rule throughout the code and is placed here only for clarity as some expenditures may fit into more than one category.

Section 63. Taxable income defined

This section is identical with section 63 of the bill as passed by the House. It is derived generally from section 21 of the 1939 Code. Taxable income is defined in subsection (a) as "gross income" minus the deductions allowed by this chapter, other than the standard deduction. Subsection (b) provides that in the case of individuals electing the standard deduction "taxable income" means "adjusted gross income" minus the standard deduction and the deduction for personal exemptions.

This change of the term "net income" as used in section 21 of the 1939 Code to "taxable income" creates a new concept. It eliminates terms such as "normal tax net income," "surtax net income" in the case of individuals, and "adjusted net income," "normal tax net income" and "corporation surtax net income" in the case of corporations and "net income" for both individuals and corporations. The change in language clarifies the tax base. It eliminates the necessity for credits against net income and exemptions which become deductions in arriving at "taxable income" for both corporations and individuals.

Part II—Items Specifically Included in Gross Income

Section 71. Alimony and separate maintenance payments

This section corresponds to section 71 of the House bill and to section 22 (k) of the 1939 Code.

Section 22 (k) provides that there be included in the wife's gross income periodic payments received from her husband subsequent to a decree of divorce or separate maintenance if such payments are received in discharge of a legal obligation imposed on the husband under the decree or under a written instrument incident to the divorce or separation. This general rule is contained in section 71 (a) (1), and additional rules contained in section 22 (k) relating to payments to support minor children and the treatment of payments of a principal sum in installments are contained in subsections (b) and (c).

Subsection (a) (2) of the House bill extends the principles of section 22 (k) to provide that there shall also be included in the wife's gross income periodic payments received from her husband subsequent to a written separation agreement if such payments are made pursuant to the terms of such agreement and because of the marital or family relationship. The periodic payments received under such agreement are includible in the wife's gross income whether or not the agreement is an instrument enforceable in a court of law. This provision, however, does not apply if the husband and wife file a single return jointly.

Under the House bill subsection (a) (2) was applicable to payments under agreements entered into in the past. Your committee's amendment would apply the subsection only to payments under agreements executed after the date of enactment of the bill.

Your committee has also added subsection (a) (3) to provide for the inclusion in the wife's gross income of periodic payments (whether or not made at regular intervals) received under a court decree (entered after the date of enactment of the bill) which requires the husband to make the payments for the support or maintenance of the wife. Subsection (a) (3) is applicable only if the wife is separated from her husband, but such separation need not be under a decree nor need the payments be made to enforce a written separation agreement. This paragraph also is not applicable if the husband and wife make a single return jointly.

Section 72. Annuities: Certain proceeds of endowment and life-insurance contracts

This section corresponds to section 72 of the House bill and to the portion of section 22 (b) (2) of the 1939 Code, which prescribes the methods of taxation of the proceeds of life insurance and endowment contracts (paid other than by reason of the death of the insured) and of annuities. In general, the section would make the following major changes from existing law:

(1) Where proceeds of a life insurance (paid other than by reason of the death of the insured), endowment, or annuity contract are received in a lump sum, the tax is computed as though the proceeds were received during a 3-year period in accordance with the principles of sections 1301 and 1302.

(2) Where proceeds of an endowment contract are received in installments, the method of taxation would be the same as in the case of an annuity.

(3) In the case of amounts received as an annuity (other than certain employee annuities), the proportionate part of each payment which is to be considered a return of investment (and thus excludable from gross income) is to be determined by the ratio which the investment in the contract bears to the expected return under the contract. The investment in the contract will be determinable from actuarial tables to be provided by the Secretary or his delegate. Once determined for a particular contract the excludable portion of the payment remains fixed despite the fact that the individual may die before or after his life expectancy. This replaces the method provided in existing

law for determining the amount includible in gross income, namely: 3 percent of the total premiums or other consideration paid until the cost of the contract has been recovered tax free.

(4) The bill provides that amounts received as a refund by the beneficiary or estate of the annuitant will be free from income tax. In view of this provision a reduction is made in the investment in the contract for purposes of computing the exclusion during the lifetime of the annuitant. This reduction corresponds to the actuarial value of the prospective refund without discount for interest.

(5) In the case of joint and survivor annuities the survivor will continue to use the exclusion ratio which was calculated in the original annuity starting date, wherever the first annuitant died after 1953. The present law, providing a step-up in basis for a survivor, is retained where the first annuitant died between 1950 and 1954. Under the bill, in lieu of the step-up in basis to the survivor, a deduction is provided in section 691 based on the estate tax attributable to a portion of the estate tax value of the survivor annuity.

(6) A separate treatment, also differing from that under present law, is provided for annuities received by an employee where a part of the consideration was contributed by an employer. In the case of such an annuity, if the employee or his beneficiary will recover, during the first 3 years in which payments under the annuity are made, all the consideration which the employee has paid (plus any paid by the employer which was includible in the employee's gross income and any amounts contributed by the employer to the extent that such amounts would not have been includible in the gross income of the employee if they had been paid directly to the employee as compensation at the time) all payments are to be excluded from gross income until such consideration has been recovered, and all payments thereafter are to be fully includible in the gross income of the individual. This rule is applicable even though the employee's annuity began prior to 1954. Thus, amounts excluded from income under the 1939 Code are added to amounts excluded under the new provisions in order to determine when payments become fully taxable.

(7) Where it is possible to take an annuity in place of the lump sum for which a contract provides (as is often the case with endowment contracts, for example), no part of the lump sum is to be deemed includible in the gross income of the individual merely by reason of the fact that the policy has matured if the individual binds himself to take the annuity instead within 60 days of such maturity. Instead, the proceeds are to be taxed under the annuity rule.

Subsection (a) of section 72 states the general rule that amounts received under an annuity, endowment, or life-insurance contract (other than amounts received by reason of death to which sec. 101 would apply or amounts excluded by other provisions of this chapter) are includible in gross income.

Subsection (b) establishes an exclusion ratio which is designed to exclude from gross income the proportionate part of each amount received as an annuity which is considered to represent a return of capital. The mathematical computation is based on the ratio which the amount invested in the contract bears to the expected return under the contract at the time the annuity is deemed to start for the purposes of the section. Payments made as annuities to survivor annuitants under joint and survivor contracts where the first annuitant died between 1950 and 1954 are given special treatment, discussed in detail under subsection (i). Otherwise subsection (b) provides for each contract a fixed exclusion ratio which is to continue until the death of the last annuitant benefiting under the terms of the contract (except that a further adjustment will be made for surviving annuitants where qualified under the provisions of sec. 691 (d) of subchapter J, relating to income in respect of decedents). Subsection (b) does not apply to any amount to which subsection (d) applies.

Subsection (c) provides the definitions for the special terms in the exclusion ratio. Under subsection (c) (1), investment in the contract is generally defined as the aggregate amount of premiums or other consideration paid for the contract less amounts, if any, received prior to the annuity starting date and not previously included in gross income. For this purpose, section 72 (f) indicates circumstances in which employer contributions to employee annuities are included in investment in the contract.

Paragraph (2) of subsection (c) provides a further adjustment where the expected return under the contract involves life expectancy of one or more persons. Before the "investment in the contract" is used in calculating the exclusion ratio it shall be reduced by the "value" of any payments to the beneficiary or estate of the annuitant which are in the nature of refunds, including payments after death by virtue of a contract providing a minimum number of payments certain. Where a refund annuity has actually begun, annuity payments having been made prior to January 1, 1954, the computation of the refund adjustment will be based upon the maximum refund payable on January 1, 1954. The determination of the value of the refund feature is to be without discount for interest and is the net actuarial value at rate of interest zero of the refund payment or payments certain as of the annuity starting date. It will be obtained by entering actuarial tables to be provided by the Secretary or his delegate with the whole number of years nearest to the quotient of the guaranteed amount divided by the payments per annum and with the age of the annuitant at the annuity starting date. The tables will yield a figure (to be applied without regard to whether the annuity is payable annually or at more frequent intervals) for each $1 per annum of annuity payment. This figure will then be multiplied by the rate of annual payment provided in the contract, the result being the value of the refund for such contract, which will be subtracted from the investment in the contract determined under subsection (c) (1). For example, on January 1, 1954, A has purchased for $17,836 an installment refund annuity contract of $1,000 per annum, and is 63 years of age on the annuity starting date. The guaranteed amount of $17,836 divided by the annual payment of $1,000 give 17.836 years as the minimum period of time from the annuity starting date for which $1,000 per year will be paid. To determine the value of the refund, A will enter the actuarial tables with his age, 63, and the nearest whole number of years to 17.836. Assuming that the factor he thus finds is 5.170, he multiplies his annual payment of $1,000 by this figure to determine the value of the refund, namely, $5,170. This latter figure is then subtracted from the tentative investment in the contract of $17,836 to obtain the adjusted investment in the contract of $12,666. This adjusted figure is to be used in determining the proportionate part of each annuity payment to be excluded from gross income. The effect of this computation is to include in the gross income of the annuitant the interest which it is anticipated will accrue from the reserve for the death benefit.

The final clause of this paragraph provides that in adjusting the investment in an employee annuity contract the value of the refund should be calculated with reference to the maximum refund that would be excluded from income by the operation of subsection (e). Assume, for example, that the employee is deemed to have contributed under paragraph (1) (a) and subsection (f) $10,000, and the employer had contributed $10,000 for a contract providing a maximum refund of $20,000 with a value of the refund feature of $5,000. Since the maximum refund that would be excluded from income by the estate or beneficiary of employee is $10,000 only half of the value of the refund feature ($2,500) should be subtracted from his investment in the contract ($10,000 less $2,500, or $7,500). If, in the above case, the contract did not provide a $20,000 refund but instead provided a refund of the employee contribution plus the interest accumulations thereon up to retirement date, the refund adjustment would still be calculated only on a prospective refund of $10,000.

Paragraph (3) of subsection (c) prescribes the method of determining "expected return" under the contract. Where the life expectancy of an annuitant or annuitants is not involved in such determination, application of subparagraph (B) to the terms of the contract (i. e., finding the total amount expected to be received as an annuity) will supply the correct result. To determine the expected return under contracts involving life expectancy or expectancies (under subpar. (A)), reference must be made to actuarial tables to be prescribed by the Secretary or his delegate. "Expected return" is limited to amounts receivable as an annuity or as annuities; it does not include other amounts which may be paid after the death of annuitants, such as are provided for in refund contracts, nor does it include anticipated dividends. Wherever payments are to be made for life as a result of the provisions of an annuity, endowment, or life-insurance contract, the tables provided by the Secretary or his delegate will provide a multiple which takes life expectancy into account in terms of total payments per annum, and is to be applied to such payments in order to obtain the expected return under such a contract. Where payments are to be made at intervals other than yearly, the number of such intervals per annum must be applied to the amount of each payment before applying the multiple obtained from the actuarial tables; thus, if payments are monthly, they are to be annualized by multiplying by 12 before applying the multiple found in the tables. Special tables are to be provided for determining the correct multiple for joint and survivor annuities. Thus, where A, 65 years of age on the annuity starting date, has purchased an annuity for payments to him for life of $1,000 per annum, his expected return will be $1,000 times the multiple he finds in the actuarial tables. Assuming this multiple to be 15.5, A would have an expected return of $15,500. Assuming that A had paid $12,000 for the contract, his exclusion ratio would be 12,000/15,500 or 24/31, and A would exclude from his gross income $774.19 of each $1,000 payment received in his taxable year. If instead A had purchased a contract calling for monthly payments of $100 each, his expected return would be $100×12×15.5, or $18,600; assuming he had paid $15,000 for such a contract, his exclusion ratio would then be 15,000/18,600, or 25/31, and A would exclude from his gross income $80.65 of each $100 payments received in his taxable year. In either of the above cases, if A had purchased a joint and survivor annuity requiring similar payments to all annuitants, he would enter the tables with his own age and that of his survivor annuitant to obtain the multiple to be used to determine expected return under the contract. The remaining computations for finding the amount of each payment to be excluded from gross income would be similar to whichever of the above examples approximates the mode of payment in the contract. If A should purchase a joint and survivor contract providing for payment of a different amount as an annuity to a surviving annuitant than to himself, however, he must first find the multiple to be used for his own payments as though the contract were an ordinary annuity with respect to him. He then calculates his own expected return independently of that of his potential survivor. A then reenters the tables with his own age and that of his potential survivor annuitant, as indicated above for a joint and survivor contract which provides the same payment throughout the life of the contract. A then takes the excess of this multiple over his first multiple and applies it to the amount of payment per annum provided for his surviving annuitant. He then adds the result to his own expected return to obtain the expected return under the contract as a whole. Special rules for the application of the same principle of the section to unusual contracts must be constructed through development of the actuarial tables to be prescribed by the Secretary or his delegate or by application of the basic principles of the section in conjunction with such tables.

Section 72 (c) (4) provides rules for determining the date as of which an annuity is considered to begin, for purposes of the application of the provisions of section 72. In general, the "annuity starting date" is the first day of the first period for which an amount is received as an annuity under the contract. However, in the case where such date is before 1954, the annuity starting date is January 1, 1954. This date is used in finding both the total consideration paid and the life expectancy. Thus, if A purchased an immediate annuity beginning January 1, 1945, his life expectancy would be determined from January 1, 1954, and the consideration to be recovered tax free over such period would be the amount paid in 1945 less such sums as have already been recovered tax free under the existing 3 percent rule. Also, if A in 1945 purchased a deferred annuity under which payments are to begin in 1960, the total consideration paid would be determined as of 1960 (i. e., the amount paid in 1945, plus any additional amounts paid, less any amounts received as dividends before 1960) and A's age in 1960 would be used in consulting the tables prescribed by the Secretary or his delegate.

Subsection (d) contains special provisions for taxing certain employee annuities. Under the provisions of the first paragraph, where an employer has contributed part of the consideration for an annuity, endowment or life insurance contract and the consideration for the contract contributed by the employee (as defined in sec. 72, with particular reference to subsec. (f)) is equal to or less than the aggregate amount receivable by the employee as an annuity during the 3 years beginning with the date an amount is first so received by the employee, all amounts received as an annuity under the contract are to be excluded from gross income until the consideration for the contract contributed by the employee has been recovered tax free. Thereafter they are fully includible in gross income. This rule shall not apply to amounts received as life insurance to which section 101 applies nor to amounts received as dividends. Paragraph (2) provides that subsection (d) applies to the beneficiary of an employee in the case where an employee dies before receiving any payments under the annuity and the subsection would otherwise apply. The final paragraph of the subsection gives a cross-reference for determination of includibility of contributions of an employer in the gross income of an employee.

Subsection (e) determines the amounts or portions of amounts to be included in gross income where such amounts are not paid as an annuity, but are nevertheless received under or in discharge of a contract involving amounts payable as annuities. In general, such amounts are included in gross income under subsection (e) (1) (A) if paid after the annuity starting date. The basis of this rule is that the exclusion ratio has already been determined and applied to amounts paid or to be paid as an annuity and such additional sums (as, for example, dividends) were not anticipatable in determining the expected return under the contract for the purpose of determining the exclusion ratio. However, under subsection (e) (1) (B), such amounts paid before the annuity starting date are only includible in the gross income of the individual to the extent that they exceed, when aggregated with other amounts paid the policyholder, the premiums or other consideration paid, including employer's contributions includible in the employee's gross income when paid and employer contributions to the extent that such amounts would not have been includible in the gross income of the employee if they had been amounts paid directly to the employee as compensation at the time. The latter treatment is also applied in subsection (e) (2) to amounts paid after the annuity starting date if in full discharge of the contractual obligation or upon the surrender, redemption, or maturity of the contract, including amounts representing the entire series of any installment refunds or payments certain after the death of an annuitant or annuitants.

Section 72 (e) (3) provides for the special treatment under which the tax on a lump-sum payment may be determined as though the payment had been received ratably in the taxable year in which received and the two preceding taxable years. Since under the rules of subsection (e) (1) and (2) the lump-sum is included in gross income only to the extent that it, with other previously untaxed amounts received, exceeds the consideration, it is only the remaining portion which is taxable.

Subsection (f) provides the method for determining the extent to which employer's contributions are treated as employee's contributions (1) for the purpose of determining the aggregate amount of premiums or other consideration paid under (c) (1) (A), (2) for the purpose of the rule of subsection (d), and (3) for the purpose of treatment of amounts (under subsec. (e) (1) (B)) not paid as annuities, but paid after the annuity starting date; hence this subsection must be taken into consideration wherever a computation involves an employee annuity. The computation is made by finding the aggregate of amounts contributed by the employer which were includible in the gross income of the employee and amounts contributed by the employer which, if paid directly to the employee at that time, would not have been includible in the employee's gross income. For example, in those situations where an employee's compensation is not includible, to some extent, in gross income by reason of his being a bona fide resident of a foreign country, contributions made by his employer to a pension fund are not later taxable to the employee any more than they would have been taxable to the employee at the time of the employer's contribution if instead they had been paid directly to the employee as compensation in accordance with the provisions of section 911.

Subsection 72 (g) provides the same transferee rule as in section 22 (b) (2) of the existing code except for adjustments necessitated by the changes made in other provisions of the section. It also enacts the rule of existing case law that a transferee is to include a beneficiary of, or the estate of, the transferee.

Subsection (h) provides for the exclusion from income of amounts payable on maturity of a contract where an option to receive payment as an annuity is elected within 60 days after the date when the lump sum is payable (eliminating the application of constructive receipt in this special case).

Subsection (i) provides a special rule for the treatment of a survivor annuitant under a joint and survivor annuity contract where the first annuitant died in 1951, 1952, or 1953. In such cases, where the basis of a surviving annuitant's interest in the contract was determinable under section 113 (a) (5) of the 1939 Code, (1) the special rule of subsection (d) relating to employee's annuities is not applicable; (2) the aggregate amount of premiums or other consideration paid is the basis of the contract determined under section 113 (a) (5); (3) in finding the sum excludable by the surviving annuitant under section 72, the premiums or other consideration paid is to be reduced only by the aggregate amount received by the surviving annuitant under the contract and excludable from his gross income prior to the annuity starting date; and (4) the annuity starting date is specially defined in subsection (i) (4) as January 1, 1954, or the first day of the first period for which the surviving annuitant receives an amount under the contract as an annuity, if such date is after January 1, 1954.

Subsection (j) specifically provides that amounts paid under an agreement to pay interest are includible in gross income. This corresponds to section 22 (b) (1) of the 1939 Code. No substantive change is made.

Subsection (k) incorporates the provision in section 22 (b) (2) of existing law in respect of amounts paid in discharge of alimony obligations, making the entire section 72 inapplicable to such payments if includible in gross income under section 71.

Subsection (l) provides that for the purposes of this section the term "endowment contract" is deemed to cover face amount certificates as defined in section (2) (a) (15) of the Investment Company Act of 1940 (15 U. S. C., sec. 80a-2). This will provide for the limit on tax in the case of the receipt of proceeds of such a contract in a lump sum which is provided in section (e) (3).

Cross-references are provided in subsection (m) to sections dealing with the basis of annuities sold or exchanged.

Your committee has made principally clarifying or technical amendments to this section as it appeared in the bill as passed by the House. A change has been made in subsection (c) (3) (A) with regard to life expectancy and its use in determining expected return under a contract. The present wording uses "expected return" in its ordinary sense and provides that it shall be computed with reference to actuarial tables to be prescribed. As this section appeared in the bill that the House passed it limited expected return to amounts expected to be received within the life expectancy or expectancies of individuals. Under this wording, the "expected return" part of the exclusion ration would rarely relate to an individual's entire life expectancy although the purpose of the section as a whole is to spread the return of the investment in the contract tax free over an individual's entire life expectancy. A very old person might have a life expectancy of but a few years and a fraction; since he could not expect to receive a fraction of a payment, his expected return would be limited to the whole number of years times his annual payment. This might eliminate any difference between his investment in the contract and his expected return—yet on the average such annuitants would be receiving a larger sum, the difference representing a sizable interest increment. The new wording enables the Secretary to indicate fractions of years in the tables to be used in computing expected return at those ages where the discrepancy between life expectancy and whole years of life expectancy is deemed to be significant.

Another change made in the section by your committee deletes subsection (j) of the House bill relating to certain joint and survivor annuities, the principle of which now appears in section 691 (d).

Your committee has also added a new subsection, (l), whose operation and purpose have been discussed above.

The other changes made by your committee were of a minor clarifying character with no intent to alter the meaning of the section from that indicated in the committee report of the House on this portion of the bill.

Section 73. Services of child

This section is identical with section 73 of the bill as passed by the House. It corresponds to section 22 (m) of the 1939 Code, except that the provision relating to assessment of tax has been deleted since it is now contained in section 6201 (c). No substantive change is made.

Section 74. Prizes and awards

This section is identical with section 74 of the bill as passed by the House. It is a new section which includes in gross income all prizes and awards with certain specified exceptions. It is intended to eliminate some existing confusion in court decisions over whether a prize is income or a gift and would overrule both the *Pot O'Gold* case (*Washburn* v. *Commissioner* (1945) 5 T. C. 1333) and the *Ross Essay Contest* case (*McDermott* v. *Commissioner* (C. A. D. C. 1945) 150 F. 2d 585) insofar as each held prizes were not income under the 1939 Code. A cross reference to section 117 (relating to scholarships and fellowship grants) is inserted to preclude taxing such awards under this section.

Subsection (b) excludes from income those prizes and awards which are made primarily to recognize past achievements of the recipient in one of the specified fields, provided the recipient was selected without any action on his part to enter the contest or to submit his works in the proceeding and provided he is not required to render any substantial future services as a condition to receiving the prize or award. Thus, such awards as the Nobel prize would be excluded under this section. Subsection (b) is not intended to exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment, such as having the largest sales record or best production record during a certain period. Amounts received from radio and television giveaway shows, or as door prizes, or in any similar type contest would also not be covered by subsection (b).

Section 75. Dealers in tax-exempt securities

This section is identical with section 75 of the House bill, and is the same as section 22 (o) of the 1939 Code.

Section 76. Mortgages made or obligations issued by joint-stock land banks

This section is identical with section 77 of the House bill. It replaces without substantive change sections 22 (j) and 3799 of the 1939 Code. The former was merely a cross reference to the latter.

Section 77. Commodity credit loans

This section is identical with section 78 of the House bill. It corresponds to section 123 of the 1939 Code and subsection (c) of such section has been deleted (relating to taxable years beginning after December 31, 1938, and before January 1, 1942). No other substantive changes have been made.

Part III.—Items Specifically Excluded From Gross Income

Section 101. Certain death benefits

This section is similar to section 101 in the bill passed by the House except as follows:

1. A conforming change has been made in subsection (a) by striking the wording providing that the subsection shall be inapplicable to proceeds of life-insurance contracts purchased by an exempt employees' trust. This restores the treatment under present law.

2. There has been inserted in subsection (a) a provision contained in existing law and eliminated by the House limiting the exclusion from gross income (in cases of transfer of a life-insurance contract for a valuable consideration) to the sum of the consideration and premiums paid by the transferee. Under existing law, the rule does not apply where the transferee has a basis determinable to any extent by reference to the basis of the contract in the hands of the transferor. Under your committee's amendment the rule also does not apply if the transfer of the contract was to the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured was a shareholder or officer.

3. A change is made in subsection (b) (2) (B) to include pension trusts among those sources of distributions to which the limitations of subparagraph (B) shall not apply.

4. Subparagraph (d) (1) (B) has been altered to provide an exclusion of $1,000 a year to the surviving spouse of an insured in addition to the proration of amounts held by insurers at the death of the insured, but any exclusions from gross income additional to such proration under this subparagraph of the House bill have been eliminated with respect to individuals standing in any different familial relationship to the insured.

This section as a whole corresponds to section 22 (b) (1) of the 1939 Code relating to the exclusion of certain death benefits from gross income.

Subsection (a) states the general rule excluding from gross income life-insurance proceeds paid by reason of the death of the insured (whether received by the decedent's estate, a beneficiary, a transferee or otherwise). The exclusion is applicable whether the insurance is payable in a lump sum or in installments except as limited in paragraph (2) of subsection (a) and subsection (d). Subsection (a) excludes death benefit payments under workmen's compensation insurance contracts or under accident and health insurance contracts which have the characteristics of life-insurance proceeds payable by reason of death.

Subsection (b) parallels section 22 (b) (1) (B) of the 1939 Code in providing a $5,000 exclusion from gross income of amounts paid by or on behalf of an employer to the beneficiaries or estate of an employee by reason of death of the employee, but sets forth the following special rules:

1. Subparagraph (B) excepts amounts to which the employee had a nonforfeitable right before death from the benefit of the exclusion (other than total distributions payable to a distributee by an exempt profit-sharing, pension, or stock bonus trust within 1 taxable year of the distributee by reason of the employee's death);

2. Subparagraph (C) excepts from the exclusion amounts paid a surviving annuitant if the employee received or was entitled to receive any annuity before his death;

3. Subparagraph (D) provides that the amount deemed to be the consideration paid by an employee for an annuity payable to a survivor to which section 72 (relating to annuities) applies shall include the amount by which the value of the annuity to the survivor exceeds the amount of any nonforfeitable right which accrued to the employee before his death, but the addition to the consideration shall not exceed $5,000 in any event and the provision will not apply to joint and survivor annuities as described in the preceding subparagraph.

The requirement under the 1939 Code that the benefits be paid under a contract has been eliminated.

Subsection (c) corresponds to existing law and provides that if life-insurance proceeds which are excludable under subsection (a) or employee death benefits which are excludable under subsection (b) are held under an agreement to pay interest thereon, the interest payments are includible in gross income.

Subsection (d) provides that the interest element contained in life-insurance proceeds which are payable (in installments, as an annuity, or otherwise) at a date later than death shall be taxed to the beneficiary, except that the surviving spouse of the insured shall be entitled to an annual exclusion with respect to such interest in the amount of $1,000.

This provision does not affect any insurance payable in a lump sum or on the date of death; nor does it affect an equivalent amount paid at a later date in whatever manner. Therefore, the subsection provides that the present value as of the date of death of life-insurance proceeds which are payable later shall be prorated over the period with respect to which such payments are to be made, such prorated amounts to be excluded from income. As in the case of regular annuities, such an annual exclusion based on the life expectancy of the beneficiary is allowed as long as he lives. All amounts received in excess of this exclusion are taxable as interest, except to the extent that the surviving spouse possesses the additional exclusion referred to above. The prorated amounts are to be excluded from gross income regardless of the taxable year in which they are actually received. If a payment is received in a taxable year other than a year in which such payment is due, that portion of such payment which represents a prorated amount shall nevertheless be excludable. The subsection is not applicable to interest received by a beneficiary under a specific agreement with the insurer to pay interest on retained proceeds, which sums continue, as under existing law, to be taxable in full without benefit of any interest exclusion.

In the ordinary case, one of the options in such contracts is an option to take a specific amount in a lump sum. This lump sum amount will be, in such cases, the "amount held by an insurer" and need only be prorated over the period payments are to be made by the insurer. For example, if at the insured's death, $1,000 would have been payable in a single installment, but 10 equal annual payments are made in lieu thereof, the portion of the installment to be excluded from gross income is $100 ($1,000 divided by 10). Any amount actually received as an installment in excess of $100 is to be included in gross income, except to the extent that the annual interest exclusion of a qualified beneficiary may apply. If payments for life were provided for in the above supposition instead of 10 equal payments, the $1,000 lump sum would be divided by the present life expectancy in years of the beneficiary concerned. Assuming the beneficiary to have an expectancy of 20 years and the lump-sum payment to be $1,000, $50 of each installment payment would be excluded from gross income and the balance included in gross income ($1,000 divided by 20), again subject to the applicable annual interest exclusion.

Special problems arise where the insurance contract does not provide for a particular amount payable immediately upon the death of the insured as an option. These are to be solved by finding the value (with respect to each beneficiary on a particular contract) of the agreement, as of the date of death of the insured, discounted on the basis of the interest rate and mortality tables used by the insurer in determining the payments. Thus, if the surviving spouse were to receive an annuity for a fixed period (or life) under one option and under the remaining option she were to receive a different sum or the same sum for a different time, and the daughter were to receive an annuity for a given period, the values to each would be determined after the wife's selection of an option, as of the date of death of the insured. For example, if the wife selected an option under which she is to receive $5,000 per year for her life, having an expectancy of 20 years, and the daughter $5,000 per year for 10 years, the discounted value to the wife might be $60,000, and that of the daughter $35,000. The wife would then exclude $3,000 of each installment from gross income ($60,000 divided by 20) and an additional $1,000 of each installment because of her special exclusion. She would then exclude a total of $4,000 of each installment from her gross income, but include $1,000 of each installment in her gross income. The daughter would exclude $3,500 of each installment from her gross income ($35,000 divided by 10). The daughter would include $1,500 of each installment in gross income.

If the mode of settlement contains refund features the yearly exclusion will be computed under regulations to be prescribed by the Secretary or his delegate, after excluding the actuarial value of such features.

This subsection changes existing law in the treatment of interest on insurance proceeds to which the subsection is applicable. Under present law "guaranteed" interest is regarded as an amount paid by reason of death of the insured and is excluded from gross income although so-called "excess" interest is regarded as an amount not paid by reason of death of the insured and is included in gross income. This distinction is abandoned and both types of interest payments are now fully includible in gross income, except to the extent they may be excluded under subparagraph (B).

This subsection will be applicable to all beneficiaries under life-insurance policies where the death of the insured occurs after the date of enactment of this act.

Subsection (e) excludes payments includible in gross income as alimony payments from the effects of the section.

Section 102. Gifts and inheritances

This section corresponds to section 102 of the House bill, containing a restatement of section 22 (b) (3) of the 1939 Code.

Section 22 (b) (3) provides for an exclusion from gross income of the value of property acquired by gift, bequest, devise, or inheritance. However, the exclusion does not apply, where the gift, bequest etc., is of income from property, to the amount of such income. The section further provides (in conformity with the amendments made to sec. 162 of the code by the Revenue Act of 1942), for treatment as gifts or bequests of income, of amounts paid out of income where, under the terms of the gift or bequest, the amounts are to be paid at intervals.

Inasmuch as the rules relating to the inclusion of income received by a beneficiary of an estate or trust have been completely rewritten in subchapter J, your committee has amended section 102 to affect correlation with the new provisions. Under the amendment, amounts which are included in income of a beneficiary under subchapter J will a fortiori, not be excluded as gifts or bequests under this section.

Section 103. Interest on certain governmental obligations

This section is identical with section 103 of the bill as passed by the House. It corresponds to section 22 (b) (4) of the 1939 Code (relating to tax-free interest). No substantive change is made. However, the instant section omits as unnecessary a provision in section 22 (b) (4) of the 1939 Code, which provided that persons owning any of the governmental obligations enumerated in that section shall, when so required by regulations, submit with his return a statement showing the number and amount of such obligations owned by him and the income received therefrom.

Section 104. Compensation for injuries or sickness

Section 22 (b) (5) of the 1939 Code excludes from gross income amounts received, as compensation for personal injuries or sickness, (1) under workmen's compensation acts, (2) through accident or health insurance, (3) as damages, and (4) as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country. Section 104 of the House bill changed existing law so as to make the exclusion under this section inapplicable to amounts received by an employee, to the extent that such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee. Your committee has amended section 104 (a) (4) of the House bill by extending the exclusion to amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country "or in the Coast and Geodetic Survey or the Public Health Service."

Otherwise, this section is identical with section 104 of the bill as passed by the House. It will continue to exclude from gross income (in the same manner as section 22 (b) (5) of the 1939 Code) any amount received as workmen's compensation under a workmen's compensation act, as well as any amount received by a taxpayer under a policy of accident or health insurance purchased by him.

Section 105. Amounts received under accident and health plans

This section corresponds to section 105 of the House bill although there have been some changes. Subsection (a) prescribes the general rule that amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee. For purposes of this section, subsection (e) provides that amounts received under an accident or health plan of an employer or of an employee association, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, which requires employers to contribute to such fund shall be treated as amounts received through accident or health insurance. An amendment to section 7701 (a) (20) of the House bill defines life insurance salesmen as employees for purposes of this section.

Subsection (b) provides that the amounts described in subsection (a) shall not be included in gross income if they are reimbursements paid directly or indirectly to the taxpayer for expenses incurred by him for medical care of the taxpayer, his spouse, and his dependents, to the extent that such reimbursed amounts are expended during the taxable year for such medical care.

Subsection (c) provides that the amounts described in subsection (a) shall not be included in gross income if they constitute payment for permanent loss, or loss of use, of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent, and the payments are computed with reference to the nature of the injury and without regard to the period the employee is absent from work. The following example will illustrate the kind of payments excludible from gross income under this subsection. Assume that under the plan of an employer payments equal to 25 percent of annual compensation are made to employees for loss of a leg. The $10,000 employee would therefore receive a payment of $2,500 and the $4,000 employee would receive a payment of $1,000. These amounts would be excludible from gross income if, under the plan, they are payable regardless of the period that the employee is absent from work.

Subsection (d) provides that amounts described in subsection (a) shall not be included in gross income if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness but only to the extent that such amounts do not exceed a weekly rate of $100 and are attributable to a period beyond the 7-day period beginning with the day on which the absence because of injury or sickness began. The Secretary or his delegate is authorized to prescribe regulations for determining the weekly rate at which such amounts are paid if such amounts are not paid on the basis of a weekly pay period. For purposes of this subsection the term "wages" is used in a broad sense to include salary and other remuneration for employment.

Subsection (f) provides special rules for the application of section 213 (a) relating to medical, dental, etc., expenses. Amounts excluded from gross income under subsection (c) or (d) would not be considered as compensation (by insurance or otherwise) for expenses paid for medical care. Accordingly, an employee receiving such amounts would be entitled not only to exclude such amounts from gross income but also to claim a medical expense deduction for any medical expenses incurred in connection with the sickness or accident. An additional special rule provides that if the taxpayer does not expend amounts which were paid to him as reimbursement for medical care during the taxable year in which the amounts are received such amounts shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care. Accordingly, where the reimbursements for medical expenses are not expended during the taxable year of reimbursement, the amounts would be included in gross income and the taxpayer would be allowed to claim a medical expense deduction when such amounts are expended in a later year.

Amounts received under workmen's compensation acts are not governed by this section. Such amounts are fully excludible from gross income in all cases under section 104.

The application of section 105 may be illustrated by the following example in which it is assumed that the employee makes no contribution to the plan.

An employer establishes a plan which provides for the payment of regular wages during a period of disability after a 7-day waiting period, but in the event of occupational injury the employee is to receive under the plan only the difference between his regular wages and the amount he receives under workmen's compensation. Employee A is injured on the job and is disabled for 8 weeks. His regular wages are $150 per week. He receives $30 per week as workmen's compensation which is excludable from gross income under section 104. After the waiting period he receives $120 per week under the plan. In addition, the employer pays A his regular wages during the 7-day waiting period, and after the waiting period A receives an additional $10 per week as extra compensation from the employer, not under a plan.

The amount received during the waiting period and the extra compensation of $10 per week (not received under a plan) constitute taxable income to A. $100 of the $120 received each week after the 7-day waiting period would be excludible from gross income.

Your committee's bill continues the general procedure in the House bill of according equal treatment to insured and noninsured sickness and accident benefits granted to employees under employer-financed plans. However, it makes the following changes in the House bill:

1. The bill spells out the precise conditions under which benefits paid as compensation for permanent injury or permanent loss of bodily function will be exempt. The House bill had merely indicated that payments compensating for injury or sickness shall be exempt.

2. The House bill confined exclusions to benefits paid under qualified plans satisfying requirements designed to prevent discrimination as to coverage on benefits in favor or highly compensated as compared with rank and file employees. The present provision eliminates these qualification requirements. However, it specifies that the exemption is to be granted only to benefits paid out under an arrangement which constitutes a plan.

3. As in the House bill the exclusion of benefits paid as compensation for loss of wages is limited to $100 a week. However, unlike the House bill the present bill makes no provision for reducing the amount of exempt benefits in cases where nonexempt benefits are provided under nonqualified plans. The bill also provides that the exemption granted for benefits paid as compensation for loss of wages shall be granted only after a period of 7 days. The House bill denied exclusions completely where there was no waiting period.

4. The bill makes it clear that the exclusion applies to benefits paid out by employee associations. It also specifically indicates that the exclusion is to be granted to benefits paid for the taxpayer's spouse and dependents as well as himself.

Section 106. Contributions by employer to accident and health plans

This section is identical with section 106 of the bill as passed by the House. Under the current interpretation of existing law, amounts paid by employers as premiums for group employee accident and health insurance, or as contributions to State accident and health benefit funds, are not included in the gross income of the employees. However, amounts which are paid by employers as premiums for individual employee policies of accident and health insurance are includible in gross income.

Section 106 provides that gross income does not include contributions by the employer to accident and health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness. The exclusion under this section is applicable whether the contribution by the employer is made by payment of an insurance premium or by some other means, such as a contribution to an independent fund maintained by the employer, by an employee association, or a State-administered fund. Also, the exclusion is applicable regardless of whether the employer's plan covers one employee or a group of employees. Therefore, the premium paid by an employe fo an individual policy of accident and health insurance for an employee will not be includible in gross income as it is under present law.

Section 107. Rental value of parsonages

This section is identical with section 107 of the bill as passed by the House. The first paragraph is derived from section 22 (b) (6) of the 1939 Code. No substantive change is made.

The second paragraph provides that the allowance paid to a minister of the gospel as part of his compensation (to the extent used by him to rent or provide a home) is not a part of his gross income. Thus, a minister who receives a rental allowance in lieu of the use of a home will be able to exclude this allowance if it is used to rent or provide a home.

The word "home" as used in both paragraphs is not intended to change the law under section 22 (b) (6) of the code of 1939 which used the term "dwelling house and appurtenances thereof." The term "home" includes the case where furnishings are also included. It does not cover cases where a minister, in addition to the home, rents a farm or business property, except to the extent that the total rental paid can be allocated to the home itself and the necessary appurtenances thereto, such as a garage.

Section 108. Income from discharge of indebtedness

This section corresponds to section 108 of the House bill and contains the provisions which in the 1939 Code were in section 22 (b) (9), relating to the income of corporations attributable to the discharge of their indebtedness, and section 22 (b) (10), relating to the discharge of the indebtedness of certain railroad corporations in reorganization. The provision formerly contained in section 22 (b) (9), now subsection (a) of this section, has been expanded so that it is applicable whether or not the indebtedness discharged was evidenced by a security. In addition, it is applicable not only to the indebtedness of a corporation but also to the indebtedness of an individual if the indebtedness was incurred or assumed by the individual in connection with the acquisition of property used in his trade or business.

In the House bill, however, income attributable to the discharge of an indebtedness may not be excluded to the extent that such discharge was effected in consideration of the transfer of property or the rendering of services. Nor is income excludable if it is includible under section 76 (b). Accordingly, the income, which is includible because the debtor had derived a tax benefit by the prior deduction of the indebtedness discharged, could not be excluded even though the debtor consents to a corresponding reduction of the basis of his property. Your committee has eliminated these restrictions since they were connected with section 76 which has been removed from the bill.

The provision 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.

Section 109. Improvements by lessee on lessor's property

This section is identical with section 109 of the House bill and in substance with section 22 (b) (11) of the 1939 Code.

Section 110. Income taxes paid by lessee corporation

This section is identical with section 110 of the bill as passed by the House. It adopts for income-tax purposes a rule applied in the excess-profits tax (under sec. 433 (a) (1) (K) of the 1939 Code as provided by sec. 101 of the Excess Profits Tax Act of 1950) with respect to railroad corporations which have entered into leases which require the lessee to pay a stated rental to the lessor free of tax. Under this provision, the payment or reimbursement of the lessor's Federal income tax (arising out of the rental) by the lessee shall be excluded from the lessor's gross income and shall not be deductible by the lessee.

This treatment is to apply only with respect to leases entered into prior to January 1, 1954. If a lease entered into prior to such date is renewed or continued after such date, it shall receive the proposed treatment if renewed or continued in accordance with an option contained in the lease on December 31, 1953. If such option was for an initial renewal and a second renewal is made under an option contained in the first renewal lease, then such second renewal will be considered to have been made in accordance with the option existing on December 31, 1953, unless the option by its terms precluded a second renewal.

Section 111. Recovery of bad debts, prior taxes and delinquency amounts

This section is identical with section 111 of the bill as passed by the House. It corresponds to section 22 (b) (12) of the 1939 Code, relating to the inclusion of amounts attributable to the recovery of bad debts, etc., and, with the exception of the change in section references, is identical with that section.

Section 112. Certain combat pay of members of the Armed Forces

This section is identical with section 112 of the bill as passed by the House. It corresponds to section 22 (b) (13) of the 1939 Code relating to the exclusion of certain compensation of members of the Armed Forces. It is identical with that section, except that the expiration date is changed from a specific date to a general provision correlating the exclusion of this section with any law relating to induction of individuals for training and service in the Armed Forces of the United States.

Section 113. Mustering-out payments for members of the Armed Forces

This section is identical with section 113 of the bill as passed by the House and corresponds to section 22 (b) (14) of the 1939 Code. No substantive change is made.

Section 114. Sports programs conducted for the American Red Cross

This section is identical with section 114 of the bill as passed by the House and corresponds to section 22 (b) (16) of the 1939 Code. No change of substance has been made.

Section 115. Income of States, municipalities, etc.

This section is identical with section 115 of the bill as passed by the House. Subsection (b) corresponds to section 116 (d) of the 1939

Code. Subsection (c) corresponds to section 116 (o) of the 1939 Code. No changes of substance have been made in either provision.

Section 116. Partial exclusion of dividends received by individuals

This section is identical with section 116 of the bill as passed by the House. This section, which should be considered in connection with section 34 (providing a credit for dividends received by individuals), excludes from gross income the first $50 of dividends received by an individual during taxable years ending after July 31, 1954, and before August 1, 1955, and the first $100 of dividends received by an individual during taxable years ending after July 31, 1955. The exclusion is denied (under subsec. (c)) to a nonresident alien whose tax is computed at a flat 30-percent rate on gross income under section 871 (a).

The restrictions and limitations prescribed by section 34 (c) and section 34 (d) also apply to the exclusion of dividend income from gross income.

In cases of taxpayers who file joint returns, the exclusion will be applicable to dividends of each of the husband and wife, so that if in 1956 a husband receives $200 of dividends and his wife $100, the wife's will be fully excluded and $100 of the husband's will also be excluded in computing the aggregate income on a joint return. The same result in the case of the exclusion will of course follow if separate returns are filed by the husband and wife.

Section 117. Scholarships and fellowship grants

Section 117 of the House bill is a new section which has no counterpart in the 1939 Code. It provides rules for determining the extent to which amounts received as scholarships and as fellowship grants are includible in gross income. Your committee has made several amendments to this section as passed by the House.

For purposes of clarification your committee has made certain technical changes in subsection (a), but no substantive change is intended. Subsection (a) states the general rule that all amounts received as scholarships or as fellowship grants are excludable from gross income. The exclusion applies also to the value of any contributed services and accommodations received by the taxpayer as a part of the scholarship or fellowship grant, such as room and board, and laundry service. In the case of a scholarship, in order for the exclusion to apply, the scholarship must be at an educational institution (as defined in sec. 151 (e) (4)). If an educational institution (as defined in sec. 151 (e) (4)) maintains or participates in a plan whereby the tuition of a child of a faculty member of any such institution is remitted at any other participating educational institution (as defined in sec. 151 (e) (4)) attended by such child, the amount of tuition so remitted shall be considered to be an amount received as a scholarship under this section. Subsection (a) excludes from gross income any amount received over and above the scholarship or fellowship grant to cover expenses for travel, research, clerical help, or equipment, which are incident to the scholarship or fellowship, but this exclusion is applicable only to the extent that such amount is so expended by the recipient.

Subsection (b) prescribes rules limiting the amount which may be excluded under subsection (a). Paragraph (1) of this subsection as passed by the House provided that the exclusion does not apply to any amount which represents payment for teaching or research services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. This paragraph has been amended by your committee so as to be applicable only to individuals who are candidates for degrees at an educational institution (as defined in sec. 151 (e) (4)). In addition, your committee has provided that this paragraph applies to "other services" in addition to teaching and research services. A new sentence has also been added at the end of paragraph (1). It provides that if teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph. The purpose of this provision is to make clear that services which constitute a part of the regular curriculum, or of the regular course of study leading to a particular degree, are not within paragraph (1). For example, if all candidates for a particular education degree are required, as a part of their regular course of study, to perform part-time practice teaching services, such services are not regarded as part-time employment for purposes of section 117 (b) (1).

Paragraph (2) of subsection (b) applies to individuals who are not candidates for degrees. Under the House bill such individuals are not permitted to exclude from gross income amounts received as scholarships or fellowship grants unless the annual amount of the scholarship or fellowship grant is less than 75 percent of the recipient's earned income during the prior 12-month period. Your committee has struck out paragraph (2) as passed by the House and has substituted a new paragraph which allows, in effect, a monthly exclusion of $300 for 36 months. This paragraph provides that in the case of an individual who is not a candidate for a degree at an educational institution (as defined in sec. 151 (e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied, and then only within the limitations provided in subparagraph (B). In order to satisfy the condition of subparagraph (A) the grantor of the scholarship or fellowship must be an organization described in section 501 (c) (3) and exempt from tax under section 501 (a), the United States, or an instrumentality thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia. Under subparagraph (B) the exclusion under subsection (a) (1) in any taxable year is limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion is allowed under subsection (a) after the recipient has been entitled to exclude, under this section, for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution.

The operation of section 117 (b) (2) may be illustrated by the following examples involving calendar year taxpayers who are not candidates for degrees:

(1) In March of the taxable year the taxpayer is awarded a postdoctorate fellowship grant which is to commence the following September 1, and is to end on June 1 of the following year. The amount

of the fellowship grant is $4,500, and the taxpayer receives this amount in monthly installments of $500 on the first day of each month. During the taxable year he receives a total of $2,000 with respect to the 4 months of September through December, inclusive. He may exclude $1,200 from gross income in the taxable year, and must include the remaining $800.

(2) Assume the same taxpayer as in the preceding example, except that he receives the full amount of the grant ($4,500) on September 1 of the taxable year. Since the amount received in the taxable year was for the full term of the fellowship (9 months), the taxpayer may exclude from gross income in the taxable year $2,700. The remaining $1,800 must be included in gross income.

(3) The 36-month limitation in subsection (b) (2) applies if the individual has received amounts excludable from gross income under subsection (a) attributable to any prior 36 months (whether or not consecutive) during which the individual was not a candidate for a degree. For example, if the taxpayer received under a fellowship grant $200 a month for 36 months he would have exhausted his eligibility under subsection (b) (2) even though he did not in any of the 36 months make use of the full $300 exclusion.

Section 118. Contributions to the capital of a corporation

This section (except for a change in a cross-reference) is identical with section 118 of the bill as passed by the House. It has no counterpart in the 1939 Code; however, the rule of this section, that contributions to the capital of a corporation are excluded from income, merely restates the existing law as developed through administration and court decisions. Determination of the basis of property contributed to the capital of a corporation is to be made under section 362.

Section 119. Meals and lodging furnished for convenience of employer

This section corresponds to section 119 of the bill as passed by the House. Existing law, as currently interpreted by the Internal Revenue Service and certain court decisions, requires that if meals or lodging represent compensation the value thereof must be included in gross income even though the employee must accept such meals or lodging in order properly to perform his duties. Under section 119 of the bill as passed by the House if meals or lodging are (1) furnished at the place of employment, and (2) are required to be accepted by the employee at the place of employment as a condition of the employment, the value thereof is excludable from the employee's gross income. Under section 119 as amended by your committee, there is excluded from the gross income of an employee the value of meals or lodging furnished to him for the convenience of his employer whether or not such meals or lodging are furnished as compensation. In the case of meals the exclusion is permitted only if the meals are furnished on the business premises of the employer. In the case of lodging the exclusion is permitted only if the employee is required to accept the lodging on the business premises of the employer as a condition of his employment. The phrase "required as a condition of his employment" means required in order for the employee to properly perform the duties of his employment.

Section 119 applies only to meals or lodging furnished in kind. Therefore, any cash allowances for meals or lodging received by an employee will continue to be includible in gross income to the extent that such allowances constitute compensation.

The operation of this section may be illustrated by the following examples:

(1) A civil-service employee of a State is employed at an institution and is required by his employer, for the convenience of the employer, to live and eat at the institution in order to be available for duty at any time. Under the applicable State statute, his meals and lodging are regarded as a part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from gross income.

(2) An employee of an institution, who is required to be on duty from 8 a. m. until 4 p. m., is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving an allowance of $30 per month in addition to his regular salary. If he elects to reside at the institution the value to the employee of the lodging furnished by the employer will be includible in gross income, because his residence at the institution is not necessary to the proper performance of his duties, and therefore is not required as a condition of his employment.

Section 120. Statutory subsistence allowance received by police

This section, which is identical with section 120 of the bill as passed by the House, is new and provides for an exclusion from gross income for any amount received as a statutory subsistence allowance by a taxpayer who is employed as a policeman by any State, Territory, or possession of the United States or any political subdivision thereof or by the District of Columbia.

The term "police official" in this section includes an employee of any of the foregoing governmental units who has police duties, such as a sheriff, a detective, or a State police trooper, however designated. For example, it encompasses the State police in Georgia who are designated the Georgia Bureau of Investigation.

The exclusion under this section is limited to a statutory subsistence allowance which does not exceed the rate of $5 per day. To the extent that any amounts received as a statutory subsistence allowance are excludable from gross income under this section, no deduction is allowable for expenses in respect of which the statutory allowance is paid; however, any expenses in excess thereof may be deducted if they are otherwise allowable ~~as a deduction.~~ For example, if a State statute provides a subsistence allowance of $5 per day, but the taxpayer, a State police trooper, incurs expenditures of $7.50 for meals while away from home overnight on official police duties, he would be entitled to a deduction of $2.50 under subparagraph (2) (B) of section 62 (relating to expenses for travel away from home). The remaining $5 would be disallowed as a deduction under this section since he is permitted to exclude $5 as a statutory subsistence allowance.

Section 121. Cross-references to other acts

This section is identical with section 121 of the bill as passed by the House. It contains cross-references to acts of Congress, not contained in the 1939 Code, which give various types of income tax-exempt status. Subsection (a) (17) thereof corresponds to section 116 (i) of the 1939 Code.

PART IV—STANDARD DEDUCTION FOR INDIVIDUALS

Section 141. Standard deduction

Section 141, which is identical with section 141 of the bill as passed by the House, corresponds to section 23 (aa) (1) of the 1939 Code, relating to the optional standard deduction for individuals. No substantive change has been made.

Section 142. Individuals not eligible for standard deduction

This section is identical with section 142 of the bill as passed by the House. It corresponds to sections 23 (aa) (4) and (5) of the 1939 Code. No substantive change is made.

Section 143. Determination of marital status

This section is identical with section 143 of the bill as passed by the House. It corresponds to section 23 (aa) (6) of the 1939 Code. No substantive change has been made.

Section 144

This section is identical with section 144 of the House bill which made no changes from present law.

Section 145. Cross-reference

This section is identical with section 145 of the House bill and contains a cross-reference to section 36, disallowing certain credits in the case of individuals electing the standard deduction.

PART V—DEDUCTIONS FOR PERSONAL EXEMPTIONS

Section 151. Allowance of deductions for personal exemptions

This section corresponds to section 151 of the House bill and to section 25 (b) (1) of the 1939 Code.

Subsection (a) provides that the exemption provided by this section shall be allowed as deductions in computing taxable income. This is a change from section 25 (b) of the 1939 Code which provided that the personal exemption should be a credit against net income.

Subsection (b) corresponds to section 25 (b) (1) (A) of the 1939 Code; subsection (c) corresponds to section 25 (b) (1) (B) of the 1939 Code; subsection (d) corresponds to section 25 (b) (1) (c) of the 1939 Code. No substantive changes are made in these provisions.

Subsection (e) deals with exemptions for dependents. It provides a $600 deduction for each dependent (as defined in section 152) whose gross income is less than $600 or who is the child of the taxpayer and has not reached the age of 19 or who is a student. This section corresponds to section 25 (b) (1) (D). However, under this section a child (a son, daughter or stepchild as defined in section 152) of the taxpayer may have gross income of more than $600 and the taxpayer may still be entitled to an exemption for him if he is under 19 years of age or is a student. A student is defined as an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins (A) is a full-time student at an educational institution; or (B) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. (The extension of the provision to on-farm training is added by your committee.)

The student at an educational institution must be a full-time student; that is, he must be enrolled for the number of hours or courses which is considered to be full-time attendance for some part of 5 calendar months. A student who attends school from February through some part of the month of June will thus qualify, or one who is enrolled for the months of February through May and then September through December will also qualify as the 5 calendar months during the calendar year need not be consecutive. Full-time attendance, of course will not include attendance at night school while holding a job during the day; this will be considered as part-time attendance.

The term "educational institution" means a school maintaining a regular faculty and established curriculum and having an organized body of students in attendance. It means primary and secondary schools, preparatory schools, colleges, universities, normal schools, technical and mechanical schools and the like, but does not include noneducational institutions, correspondence schools, on the job training, night schools and the like.

Section 152. Dependent defined

This section, except for one minor change, corresponds to section 152 of the House bill. It corresponds to section 25 (b) (3) of the 1939 Code but has several new provisions.

Subsection (a) corresponds to the first sentence in section 25 (b) (3) of the 1939 Code. It defines a dependent as in section 25 (b) (3) of the Code of 1939 as an individual, described in paragraphs 1 to 8 (subparagraphs A through H of section 25 (b) (3) of the 1939 Code) over one-half of whose support (for the calendar year in which the taxable year of the taxpayer begins) is received from the taxpayer. No substantive change is made as to such paragraphs. To the list of eligible individuals is added a ninth classification—any individual who is a member of the taxpayer's household and whose principal place of abode for the taxable year of the taxpayer is the home of the taxpayer, and a tenth classification—an individual who is a cousin of the taxpayer and who, for the taxable year of the taxpayer requires institutional care because of physical or mental disability and before receiving such care was a member of the same household as the taxpayer.

Paragraph (9) is intended to apply only when the taxpayer and such other members of his household live together in such household during the entire taxable year (except for temporary absences due to special circumstances). The fact that such individual may be at college during the college term does not prevent the home of the taxpayer from also constituting the principal place of abode of such individual. However, such home will not be considered as the principal place of abode where the child establishes a separate habitation and only returns for periodic visits. Similarly, such home will not be considered as constituting the principal place of abode of a dependent of the taxpayer who is supported by the taxpayer for a part of the year in lodgings other than those occupied by the taxpayer even though such person may at various periods live in the household, unless the residence of the dependent in other lodgings is due to necessity such as illness. It is also intended that the household constitute the actual place of abode of the taxpayer and it is not sufficient that the taxpayer maintain the household without being an occupant thereof. For example, under paragraph (9) the taxpayer will be entitled to claim a foster child (who is not legally adopted) as a dependent (assuming the support and earnings tests are met) provided the foster child is a member of the taxpayer's household and lives in the taxpayer's home for the entire taxable year, except for vacations or time away at school.

Subsection (b) contains rules relating to definitions. Paragraph (1) is derived from the second sentence of section 25 (b) (3) of the 1939 Code. Paragraph (2) is derived from the first clause of the third sentence of section 25 (b) (3) of the 1939 Code. No substantive change is made in either of these provisions. Paragraph (3) is derived from the fourth sentence of section 25 (b) (3) of the 1939 Code. The general rule of this paragraph, both in the House bill and under the 1939 Code, is that a citizen or subject of a foreign country may not qualify as a dependent unless he is a resident of the United States or of certain designated countries. Your committee has modified the rule so that the disqualification will only apply to a noncitizen of the United States. This is to permit a person who may be a citizen both of the United States and of another country to be treated as any other citizen of the United States. In the case of noncitizens, the exceptions applicable to residents of contiguous countries provided by existing law, and the additional exceptions added by the House bill for residents of the Canal Zone, the Republic of Panama, and, in certain cases, of the Philippines, are retained.

Paragraph (4) of subsection (b) is derived from the fifth sentence of section 25 (b) (3) of the 1939 Code and no substantive change is made.

Subsection (c) provides a new concept of multiple support; that is, where two or more taxpayers contribute to the support of a dependent no one contributing over one-half of such support. This subsection provides that any one of a group who contributes to the support of a dependent may be designated by the others in the group to take the dependency exemption for a dependent supported by the group. There are four requirements which must be met in order to assign the dependency exemption:

1. No one person contributed over one-half of the dependent's support.

2. Each member of the group would have been entitled to the dependency exemption except for the support requirement. That is, the dependent must be within the required relationship and be a resident of the United States or other countries specified in subsection (b) (3).

3. The member of the group claiming the dependency exemption must have contributed more than 10 percent of the dependent's support.

4. Each other person in the group who contributed more than 10 percent of the support of the dependent in the calendar year, must file a written declaration that he will not claim the exemption for the dependent in the same calendar year (or any taxable year beginning in such calendar year).

The operation of subsection (c) may be illustrated by the following examples:

1. A and his brothers B and C contribute $500 each per year toward the support of their mother M. Under section 25 (b) of the code of

1939 none of the brothers could claim M as a dependent, hence her dependency exemption was lost. Under subsection (c), however, 1 of the 3 brothers may claim a dependency exemption for M since (a) no one person contributed one-half of her support, (b) each of the brothers could have claimed M as a dependent except for the support test, (c) each contributed over 10 percent of her support, and (d) if each of the brothers other than the one claiming the deduction files a written declaration (pursuant to regulations issued by the Secretary or his delegate) that he will not claim M as a dependent for the taxable year beginning in the calendar year of such support.

2. If M contributes $500 toward her own support and her sons A and B each contribute $300, the sons will be eligible for the deduction if one files the declarations as explained above. They are eligible since they, as a group, have contributed over one-half of M's support.

Subsection (d) contains a new provision for special support test where a dependent child (son, daughter, or stepchild as defined in subsection (b) (2)) is a student as defined in section 151 (e) (4) (an individual who is a full-time student at an educational institution during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins) at an educational institution as defined in section 151 (e) (4) (a school maintaining a regular faculty and an established curriculum and having an organized body of students in attendance). Amounts received as scholarships (from whatever source derived and however paid), for study at such an educational institution shall not be considered in computing whether the taxpayer furnishes one-half the support of such child. For example: A has a child C who receives a $1,000 scholarship to the X college for 1 year. A contributes $500 toward the child's support at college and C has no income of his own. A may claim C as a dependent as the $1,000 scholarship is not counted in determining the support of C. Amounts received as tuition payments and subsistence allowances by a veteran pursuant to the provisions of the Servicemen's Readjustment Act of 1944 are not amounts received as scholarships.

Section 153. Determination of marital status

This section is identical with section 153 of the House bill and corresponds without change in substance to section 25 (b) (2) of the 1939 Code.

Section 154. Cross references

This section corresponds to section 154 of the House bill, except for the deletion of the reference to section 443, relating to prorating of exemptions.

Part VI—Itemized Deductions for Individuals and Corporations

Section 161. Allowance of deductions

This section is identical with section 161 of the bill as it passed the House. It states the general rule that in computing taxable income there shall be allowed the deductions specifically provided in the other sections of part VI relating to itemized deductions for individuals and corporations.

Section 162. Trade or business expenses

This section, except for deletion of a cross reference, is identical with section 162 of the bill as it passed the House.

The first sentence of subsection (a) corresponds to the first sentence of section 23 (a) (1) (A) of the 1939 Code. The second sentence of subsection (a) is derived from the Legislative-Judiciary Appropriations Act, 1954. No substantive change is made in these provisions.

Subsection (b) is derived from section 23 (a) (1) (B) of the 1939 code. This section provides that no business deduction is available for any contribution which would be deductible as a charitable gift, were it not for the percentage limitation on such gifts. This was the rule for corporations under section 23 (a) (1) (B) of the 1939 Code and this section now extends the rule to individuals. No substantive change is made in the application of this rule. As under present law, it applies only to gifts, i. e., those contributions which are made with no expectation of a financial return commensurate with the amount of the gift. For example, the limitation would not apply to a payment by an individual to a hospital in consideration of a binding obligation to provide medical treatment for the individual's employees. It would apply only if there were no expectation of any quid pro quo from the hospital.

Section 163. Interest

This section corresponds to section 163 of the House bill and to section 23 (b) of the 1939 Code. Subsection (a) in the House bill contains the deduction for interest contained in section 23 (b), while subsection (b) provides for the deduction of certain carrying charges as interest in the event that the interest charged cannot be ascertained.

Your committee's amendment would eliminate the new provisions of subsection (b) and would have the section incorporate the provisions of existing law.

Section 164. Taxes

This section corresponds to section 164 of the House bill.

Subsections (a), (b), and (c) of section 164 incorporate provisions contained in section 23 (c) of the 1939 Code. There is some rearrangement of the provisions, particularly subsection (c), but no substantive change is made. Subsection (b) (7) is a new provision necessitated by the new rule provided in subsection (d). Subsection (e) contains the substance of section 23 (d) of the 1939 Code in rearranged form without any change in effect.

Your committee has amended subsection (b) (5) to provide for the deduction of taxes levied by a special taxing district which covers the whole of at least 1 county and which includes at least 1,000 individuals paying the taxes levied by the special taxing district. The amendment further provides that the deduction is available only if the district levies its assessment annually at a uniform rate on the same assessed value of real property (including improvements) as is used for purposes of real property taxes generally.

Your committee has stricken subparagraph (b) (8) as to tax imposed by section 309 (relating to transfers in redemption of nonparticipating stock).

Subsection (d) is a new provision for treatment of current taxes on real property. Under *Magruder* v. *Supplee* (316 U. S. 394 (1942)), a purchaser may not deduct a pro rata share of real property taxes assumed under the purchase contract if the seller was personally liable for the tax and a lien had attached to the property prior to the sale. Subsection (d) treats the purchaser, for tax purposes, as the person upon whom the tax is imposed for the portion of the real property tax year beginning on the date of the closing of the sale. The seller is the person upon whom the tax is imposed for the portion of the period preceding date. The provision applies whether or not the parties do apportion the tax. Subsection (b) (7) denies a deduction for taxes to the extent that under subsection (d) the taxes are treated as imposed on another.

The new provision will enable the purchaser and seller to deduct when paid or accrued, whichever is appropriate under the taxpayer's method of accounting, the portion of the tax treated as imposed upon him. If, however, the taxpayer uses the cash receipts and disbursements method and hence cannot deduct any amount for taxes until paid, and if the other party to the sale is personally liable for the tax, the taxpayer is considered to have paid, at the time of the sale, the portion of the tax treated under this subsection as imposed upon him. If neither party is personally liable for the tax, the rule also applies if the other party holds the property at the time that the tax becomes a lien. These rules will permit the cash basis taxpayer to obtain the benefits of this subsection even though he does not make the actual tax payment and there will be no necessity to determine when the tax is in fact paid.

By reason of the change made in section 461 (c) by your committee, which makes the ratable accrual of real property taxes an elective rule, there has been added a special rule in subsection (d) (3) for sales of real property involving taxpayers on an accrual basis who have not elected to accrue real property taxes ratably. In the case of the sale of real property involving such taxpayers the apportionment rule provided by subsection (d) will not be available. In those cases the rule of existing law on treatment of the deduction of taxes will be applied. Thus if an accrual basis taxpayer has before the sale accrued the taxes on the lien date, the other party to the sale who may in fact pay the taxes may add the taxes so paid to his basis. Under the circumstances described above, both the buyer and seller may benefit by knowing the basis of accounting of the other and whether or not either has made an election under section 461 (c).

Subsection (d) does not affect the treatment of any assumption of delinquent taxes by the purchaser. Such a purchaser assumes and pays delinquent taxes to procure an unencumbered title and the payments will continue to be treated as part of the purchase price of the property.

Subsection (d) applies to taxable years ending after December 31, 1953, if the sale takes place after December 31, 1953. However, if the tax was an allowable deduction to the seller under the 1939 Code, subsection (d) does not apply.

It appears that the House bill is not clear as to the treatment of the reimbursement for taxes paid by a cash-basis taxpayer before the date of the sale of real property. In order to clarify this point your committee intends that if a cash-basis taxpayer has, in a taxable year, prior to sale, deducted an amount in excess of the portion of the tax treated as imposed upon him under subsection (d), the excess will be includible in gross income for the year of the sale subject to the provisions of section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts).

In applying section 1001 (b) (relating to treatment of amount realized on sale or other disposition of property) the amount realized on a sale of real property will not include any amount of tax treated under subsection (d) as imposed upon the seller. Similarly, in applying section 1012 (relating to basis of property) the cost of the property does not include any amount in respect of taxes which are treated as imposed on the purchaser. In each case an exception is made in the case of section 266 (relating to election to capitalize certain carrying charges and taxes).

Paragraph B of subsection (d) (2) of the House bill has been changed to C. Paragraph C of subsection (d) (2) of the House bill has been changed to D.

Section 165. Losses

This section corresponds to section 165 of the bill as it passed the House.

Rules for the treatment of losses contained in various subsections of section 23 of the 1939 Code have been brought together in this section.

The general rule for losses of individuals (sec. 23 (e)) and the rule for corporations (sec. 23 (f)) become subsections (a) and (c). The reference to the basis for determining the amount of any loss (sec. 23 (i)) is now subsection (b). The treatment of wagering losses (sec. 23 (h)) is contained in subsection (d). The reference to capital losses (sec. 23 (g) (1)) is now subsection (f). No substantive change is made by this rearrangement.

Subsection (e) is a new provision for the treatment of theft losses. There was no comparable statutory provision in the 1939 Code. Regulation 118, section 39.43-2 provides that a loss from theft or embezzlement is ordinarily deductible for the year in which sustained. There has been considerable uncertainty and litigation about the application of this rule. Under the new provision, the loss will always be deductible in the year in which the taxpayer discovers the loss. The rule will, of course, also apply to embezzlement, larceny, etc. If the loss is treated as sustained under this subsection, there can be no deduction for the same loss under the 1939 Code for a prior year (see sec. 7852).

Subsection (g) deals with losses from worthless securities. The general rule contained in paragraph (1) incorporates provisions contained in section 23 (g) (2) and (k) (2). The definition of security in paragraph (2) was adopted from section 23 (g) (3) and (k) (3). The treatment of stock in affiliated corporation under paragraph (3) picks up the provisions of section 23 (g) (4) and (k) (5).

When the securities in an affiliated corporation which qualifies as such under section 165 (g) (3) become worthless the loss may be deducted as ordinary. Under the House bill two changes were made in the definition of affiliated corporations for the purposes of subsection (g) (3).

The first change relates to the requirement that a certain percentage of the income of the affiliated corporation must be from specified sources (i. e., generally from the operation of a trade or business). Under the 1939 Code this requirement was set at 90 percent of the aggregate of its gross income for all taxable years. Subparagraph (b) has changed this provision to 90 percent of the aggregate of its gross receipts. It should be noted that in computing gross receipts under this subparagraph, gross receipts from the sale or exchange of stock and securities will be taken into account only to the extent of the gains from such sales or exchanges. This change has been retained by your committee.

The second change relates to the percentage of stock of the subsidiary which must be owned by the taxpayer. In accordance with the change made with respect to the stock ownership requirement in the case of corporations electing to file a consolidated return the percentage was reduced in the House bill from 95 percent to 80 percent. In view of your committee's action in restoring the consolidated returns provisions to those under existing law, your committee has restored the 95 percent requirement for purposes of section 165 (g) (3).

It should be noted that the changes relating to loss on securities in an affiliated corporation becoming worthless do not affect the result reached in the Tax Court decision of *Hunter Manufacturing Corporation* (21 T. C. No. 52), which indicated that the loss from the securities of an affiliated corporation becoming worthless could not be converted from a capital loss into an ordinary loss if additional stock is purchased solely for the purpose of bringing the holdings of the taxpayer up to the minimum stock ownership requirements in order to obtain such an ordinary loss.

Section 166. Bad debts

This section corresponds to section 166 of the House bill, except for the elimination of subsection 166 (f) which was designed to conform the bad-debt provisions to the provisions of section 1035, relating to mortgage foreclosures, which has also been eliminated by your committee.

Subsection (a) contains the general rule for the treatment of bad debts found in section 23 (k) (1) of the 1939 Code. No substantive change is made.

Subsection (b) adopts the provisions of section 23 (i) of the 1939 Code with respect to the basis for determining loss from bad debts.

Subsection (c) permits a reserve for bad debts in the discretion of the Secretary or his delegate. Section 23 (k) (1) of the 1939 Code contained the same provision.

Subsection (d) relating to nonbusiness bad debts of taxpayers other than corporations incorporates provisions contained in section 23 (k) (4) of the 1939 Code with certain substantive changes. Nonbusiness bad debts continue to be treated as short-term capital losses. Two types of indebtedness are specifically excluded from the definition of nonbusiness bad debts. First, debts which become worthless in the course of the trade or business of the taxpayer. This is the only type of indebtedness which was excluded from the definition of nonbusiness bad debt under existing law. Second, any debt which is either created in the course of the trade or business of the taxpayer or is acquired by him in the course thereof without regard to the relationship of the debt to a trade or business of the taxpayer at the time that the debt becomes worthless, shall not be treated as a nonbusiness bad debt.

The applicability of subsection (d) still depends upon the existence of a bona fide debt as distinguished from a gift or a contribution to the capital of the corporation. Once it is determined that there is a bona fide debt, the debt may be characterized as a business bad debt under subsection (a) or a nonbusiness bad debt under (d) depending on the circumstances.

Subsection (e) provides that debts evidenced by a security as defined in section 165 (g) (2) (C) are not subject to treatment under the section. As part of the rearrangement a general rule for treatment of worthless securities is contained in section 165. The result reached under that section is the same as the result reached under the 1939 code by excluding debts in section 23 (k) (4) and providing for the treatment of worthless securities, as defined in section 23 (k) (3), and in section 23 (k) (2).

Your committee has added a new provision, subsection (f), relating to the tax treatment of guarantors of certain noncorporate obligations. (This is a replacement of subsection (f) of the House bill, which related to mortgage foreclosures and was stricken by your committee.)

This subsection will allow a deduction from gross income for a loss suffered by a noncorporate taxpayer through payment during the taxable year of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation. In order to obtain an ordinary loss, the taxpayer must establish that the proceeds of the loan were used in the trade or business of the borrower and that the obligation of the borrower, to the person to whom the taxpayer made payment in discharge of his guarantor's obligation, was worthless at the time of such payment (without regard to the guaranty, endorsement, or indemnity). The term "guarantor, endorser, or indemnitor," includes not only those persons having collateral obligations as guarantors or endorsers but also those persons having direct obligations as indemnitors.

The payment by the taxpayer of such obligation will result in the treatment of such payment as a debt becoming worthless during the taxable year under the general rule of the section and all other rules of the section (other than subsection (d)) become applicable. Thus a taxpayer who makes only a partial payment in discharge of his obligation as a guarantor (the other portion of the original debt having been collected from the borrower) may treat such payment as being within subsection (a) (2) if the taxpayer can establish that the remaining obligation of the borrower to the person to whom the taxpayer makes payment was worthless at the time of such payment. Other provisions of the code relating to bad debts, such as section 111 (relating to recovery of bad debts) will be applicable to the payment.

If the requirements of this section are not met, the taxpayer will, as under present law, be treated taxwise under whatever provisions of the code are applicable in the factual situation. However, if the requirements are met, he will obtain a deduction from ordinary income and the nonbusiness bad-debt rules of subsection (d) (treating the loss as a short-term capital loss) will not be applicable.

Section 167. Depreciation

This section corresponds to section 167 of the House bill with changes as hereinafter mentioned.

Subsection (a) is identical with the same provision of the House bill. Subsection (a) of this section contains the same language as was contained in the first sentence of section 23 (l) of the 1939 Code. Methods which have previously proved reasonable may continue to be used and other methods which prove reasonable may also be used under this subsection.

Subsection (b) corresponds to the same provision of the House bill. Subsection (b) provides methods which, for taxable years ending after December 31, 1954, will be deemed to produce a reasonable allowance for depreciation of property described in subsection (c) so long as the useful life used in determining such allowance is accurate. Your committee has struck the word "one" from the phrase "an allowance computed in accordance with regulations prescribed by the Secretary or his delegate under one of the following methods:". This word was deleted to make it clear that more than one method may be used on various property or classes of property of a taxpayer. For example, a taxpayer may use the straight-line method of depreciation on buildings while using the declining balance method on machinery. The methods described in subsection (b) are:

(1) The straight-line method—

Under this method, the cost or other basis of the property, less its estimated salvage value, is deducted in equal annual installments over the period of its estimated useful life. The depreciation deduction is obtained by dividing the amount to be depreciated by the estimated useful life. This may be expressed as a rate of depreciation computed by dividing the estimated life into 1. The deduction per taxable year may be arrived at by multiplying the cost or other basis (less salvage value) by the resulting rate.

(2) Declining balance method—

Under this method a uniform rate is applied to the unrecovered basis of the asset. Since the basis is always reduced by prior depreciation, the rate is applied to a constantly declining basis. The salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value. 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). Under section 23 (l) of the 1939 Code the declining balance method was allowed in certain instances but the rate was generally limited to 1¼ times of the rate used under the straight-line method. If this method has been used for property acquired prior to December 31, 1953, it may continue to be used but the rate provided for in paragraph (2) will not be presumed to be reasonable with respect to such property.

(3) The sum of the years-digits method—

Your committee has added the sum of the years-digits method to those methods provided in the House bill which will be deemed to produce a reasonable allowance. Under this method the annual allowance is computed by applying a changing fraction to the taxpayer's cost of the property reduced by the estimated salvage value. The denominator of the fraction is the sum of the numbers representing the successive 12-month periods in the estimated life of the property and the numerator of which is the number of 12-month periods, including that for which the allowance is being computed, remaining in the estimated useful life of the property. This method of depreciation can best be illustrated by an example. A acquires new property in 1954 which costs $175, has an estimated useful life of

5 years and an estimated salvage value of $25. The depreciation schedule for the asset will be as follows:

Year	Fraction of cost less salvage ($175−25=150)[1]	Depreciation deduction	Total reserve	Adjusted basis
1	5/15	$50	$50	$125
2	4/15	40	90	85
3	3/15	30	120	55
4	2/15	20	140	35
5	1/15	10	150	25
Total		150		

[1] The denominator of the fraction is determined by adding 1+2+3+4+5=15.

(4) Other consistent methods—

Any other method consistently applied which will not, during the first two-thirds of the useful life of the property, yield a greater depreciation reserve than would have been accumulated had the method described in paragraph (2) been used. Your committee has added the qualification "during the first two-thirds of the useful life of the property" so as not to restrict unduly the use of multiple rate straight-line methods and other methods which because of a small salvage value accumulate a greater reserve for depreciation in the latter years of an asset's life than would have accumulated automatically under the declining balance method.

Your committee has added a new sentence to subsection (b) to make it clear that all methods which have been allowed in the past will continue to be allowed. Those allowances which have proved reasonable under section 23 (1) of the 1939 Code will, of course, continue to be allowed.

Your committee has completely rewritten subsection (c). Subsection (c) defines the property with respect to which subsection (b) applies. Subsection (b) does not apply to intangible property such as patents, copyrights, and leases, etc. Your committee has eliminated the word "personal" as leases are meant to be excluded for allowances provided for by methods allowed in subsection (b). The allowances provided in subsection (b) shall apply only to depreciable property with a useful life of 3 years or more—

(1) the original use of which commences after December 31, 1953, and commences with the taxpayer; and

(2) the acquisition, construction, reconstruction or erection of which is made or completed after December 31, 1953.

Your committee has changed the requirement in the House bill that the methods provided by subsection (b) would be deemed reasonable only for that part of the basis of property completed after December 31, 1953, which is properly attributable to the construction, reconstruction, or erection after such date, to allow such allowances for the entire cost of property completed, and first put into use after December 31, 1953. This new rule will do away with many difficult problems of allocation and many difficult questions of to what period are various expenses attributable. Thus under this subsection property construction of which began in 1953 and which was completed in a subsequent year would be eligible for the allowances under subsection (b) when first put into use after December 31, 1953. The limitation was further applied to property with a life of 3 or more years to prevent unreasonable accumulation of depreciation allowances in the case of property with a relatively short life. Under the declining balance method an asset with a 2-year life and thus a 50 percent straight-line rate would be charged off 100 percent in the first year if this limitation did not apply. The reasonableness of depreciation deductions for property completed and put into use prior to January 1, 1954 will be determined under subsection (a). However, with respect to capital additions to such property or reconstruction costs with respect thereto completed and put into use after December 13, 1954, an allowance for depreciation computed under any of the methods described in subxection (b) will be reasonable.

Property which is described in paragraph (c) includes property acquired after December 31, 1953, but only if the original use of the property is commenced with the taxpayer and is commenced after that date. Thus such property must be new in use, that is, never before having been subject to depreciation whether or not depreciation deductions relating to such property were allowable. Thus if A acquires title to a machine from the manufacturer after December 31, 1953, and puts it into use for the first time thereafter, the use of the methods described in subsection (b) will result in allowances which will be reasonable. However, if A buys a machine on January 2, 1954, from B, who had used the machine prior to December 31, 1953, the allowance resulting from the use of the methods described in subsection (b) will not be presumed reasonable inasmuch as the original use of the machine does not commence with A. The depreciation allowances with respect to previously used items will be computed under subsection (a) as they were under the Internal Revenue Code of 1939. If A purchases a machine which had been used prior to December 31, 1953, from the X company which had in 1954 taken the machine as a trade-in and reconditioned it, the allowances resulting from the use of the methods described in subsection (b) will not be presumed reasonable inasmuch as the original use of the machine had begun prior to A's acquisition thereof.

A, on January 2, 1954, purchases property for $20,000 from B which B had used as a personal residence prior to January 1, 1954. A makes a capital addition to the property at a cost of $5,000 and on July 1, 1954, A rents the property to C. A depreciation allowance computed under one of the methods described in subsection (b) will be presumed reasonable for the $5,000 addition which is completed and put into use after December 31, 1953. Therefore, A may use with respect to the $5,000 addition an allowance computed under the declining balance method using 200 percent of the rate which would have been used had he used the straight-line method. On the $20,000 of cost, however, A may use only an allowance computed under subsection (a) as this property was not new when acquired by A. If A wishes to depreciate the total cost ($25,000) as one unit the reasonableness of the depreciation deductions will be determined under subsection (a).

Assume in the preceeding example that A sells the house to D for $21,000 at a time when the adjusted basis of the house is $12,000 and the adjusted basis of the addition is $2,000. The deductions resulting from the use of methods provided by subsection (b) on either the house or the addition will not be deemed reasonable inasmuch as D is not the original user of either the house or the addition.

Where the methods provided for in subsection (b) are availed of, separate asset and depreciation records must be maintained for property so depreciated. Thus, A, who had a storage tank which he erected before January 1, 1954, erected another tank after December 31, 1953. A must maintain separate asset and depreciation records for the tank erected before January 1, 1954, and for the one erected after that date if he desires to depreciate the new tank under subsection (b).

There need be no formal election to compute the depreciation allowance under the methods provided for in subsection (b). In order for a taxpayer to use these methods, 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.

In the case of item 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 account and must be applied to that account consistently thereafter.

A computation of the depreciation deduction under the declining balance method on a group account may be illustrated by the following example:

Example.—A maintains a group asset account to which he wishes to apply the declining-balance method of depreciation. The average useful life of the assets in this account is determined to be 5 years. The appropriate straight-line depreciation rate is 20 percent. A uses the maximum rate allowable under the declining-balance method, 40 percent. Six new-in-use assets are acquired July 1 of the first year at a cost of $2,000 each, and are assumed to be retired one in each of the third, fourth, sixth, and seventh years of service, and two in the fifth year of service. The salvage values are shown in the table. A acquires 5 additional assets in the fifth year at a cost of $2,000 each. The group depreciation account is illustrated in the following table 1:

TABLE 1.—*Group depreciation account—Estimated life 5 years (straight line rate 20 percent; declining balance rate 40 percent; retirements assumed at 3, 4, 5, 5, 6, and 7 years)*

Year	Description	Asset account			Accumulated depreciation			Net depreciable balance
		Original cost	Retirements and disposals	Balance	Annual charge	Retirements and disposals	Balance	
1 (July 1)	Acquired 6 units at $2,000 each.	$12,000		$12,000	$2,400		$2,400	$9,600
2				12,000	3,840		6,240	5,760
3				12,000	2,304		8,544	3,456
4 (June 30)	Retired 1 unit, $200 salvage.		$2,000	10,000	1,342	$1,800	8,086	1,914
5 (June 30)	Retired 1 unit, $200 salvage.		2,000	8,000	720	1,800	7,012	988
6 (June 30)	Retired 2 units, $400 salvage.		4,000	4,000	816	3,600	3,728	272
(July 1)	Acquired 5 units, at $2,000 each.	10,000		14,000	2,000		5,728	8,272
7 (June 30)	Retired 1 unit, no salvage		2,000	12,000	3,309	2,000	7,037	4,963
8 (June 30)	Retired 1 unit no salvage		2,000	10,000	1,953 130	2,000	6,990 7,120	3,010 2,880

In the year of acquisition depreciation is taken for that portion of the year for which the assets are actually in service. In the example above acquisitions in years 1 and 6 are assumed to have been put into use on July 1, hence, only one-half of a year's depreciation is taken for the first year. Similar adjustment is made in the depreciation deduction upon retirement of assets where salvage is realized. On retirement the asset account is reduced by the full cost of the asset and the accumulated depreciation account is reduced by the full cost of the asset less the amount realized as salvage.

It should be noted that in the year that the last survivor of the year 1 acquisitions is retired (year 8), an additional depreciation deduction of $130 is allowed equal to the unrecovered cost of the year 1 acquisitions.

Only a taxpayer who maintains subsidiary depreciation records by year of acquisition, in addition to the group account, will have sufficient information to determine (1) the year in which the last survivor of a given year's acquisitions is retired and (2) the unrecovered cost of that year's acquisitions. These subsidiary records may be illustrated by the two tables below. Table 2 shows the year 1 assets and table 3 shows the year 6 acquisitions. These same principles apply to both composite and classified accounts:

Depreciation account—estimated life, 5 years

TABLE 2.—YEAR 1 ACQUISITIONS

Year	Asset account			Accumulated depreciation			Net depreciable balance
	Cost	Retirements and disposals	Balance	Annual charge	Retirements and disposals	Balance	
1 (July 1)	$12,000		$12,000	$2,400		$2,400	$9,600
2			12,000	3,840		6,240	5,760
3			12,000	2,304		8,544	3,456
4 (July 1)		$2,000	10,000	691 651	$1,800	3,086	1,914
5 (July 1)		2,000	8,000	383 343	1,800	7,012	988
6 (July 1)		4,000	4,000	198 118	3,600	3,728	272
7 (July 1)		2,000	2,000	109	2,000	1,837	163
8 (July 1)		2,000		33	2,000	--130	130
8 (Dec. 31; unrecovered balance, additional depreciation)				130			

TABLE 3.—YEAR 6 ACQUISITIONS

Year	Asset account			Accumulated depreciation			Net depreciable balance
	Cost	Retirements and disposals	Balance	Annual charge	Retirements and disposals	Balance	
6 (July 1)	$10,000		$10,000	$2,000		$2,000	$8,000
7			10,000	3,200		5,200	4,800
8			10,000	1,920		7,120	2,880

Subsection (d) is identical with the same provision of the House bill.

Subsection (d) provides for specific agreements of a binding nature between the Secretary or his delegate and a taxpayer. It provides that any time after the date of enactment of this act, under regulations prescribed by the Secretary or his delegate, a written agreement between the Secretary (or his delegate) and the taxpayer may be made, specifically dealing with the useful life and the rate of depreciation of any property. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. A change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life or rate is sent by registered mail by the party proposing the change to the other party.

Your committee has deleted subsection (e) of the House bill as present administrative action has relieved the problem of minor disagreements as to useful life of property. Recent rulings of the Internal Revenue Service have prescribed that adjustments to depreciation deductions will only be made when there is a clear and convincing basis for such a change.

Your committee has added a new subsection (e) which provides that, in the absence of an agreement made under subsection (d) providing to the contrary, the taxpayer may under regulations prescribed by the Secretary or his delegate change from the declining balance method to the straight-line method of computing the depreciation deduction. The taxpayer must, of course, at the time of the change estimate a realistic salvage value and useful life. All changes in depreciation method are changes in accounting method under section 446 (e) and, therefore, will require the consent of the Secretary or his delegate.

The change in method provided by this subsection, however, may be made at any time, under regulations, without such permission. Except for property being depreciated in item accounts the taxpayer must maintain subsidiary depreciation records by year of acquisition, in addition to his group or composite account in order to have sufficient information to make such a change to a year's acquisitions.

Subsections (f) and (g) are identical to those provisions of the House bill. Subsection (f) corresponds to section 114 (a) of the 1939 Code. Subsection (g) corresponds to the second and third sentences of section 23 (1) of the 1939 Code. No substantive changes are made.

Your committee has substituted the word "additional" for the word "special" in subsection (h) of the House bill. This subsection contains a cross-reference to section 611 for additional rules for depreciation of improvements in the case of mine, oil and gas wells, other mineral deposits, and timber. Mine improvements may, of course, be depreciated under this section.

Section 168. Amortization of emergency facilities

This section, except for a conforming change, corresponds to section 168 of the bill as it passed the House, corresponds to section 124A of the 1939 Code. No substantive change is made.

Section 169. Amortization of grain storage facilities

This section, which is identical with section 169 of the bill as it passed the House, corresponds to section 124B of the 1939 Code. No substantive change is made.

Section 170. Charitable contributions and gifts

This section corresponds to section 170 of the House bill. It consolidates section 23 (o) of the 1939 Code, relating to charitable contributions by individuals; section 23 (q) of the 1939 Code, relating to charitable contributions by corporations; and section 120 of the 1939 Code, relating to the unlimited deduction of charitable contributions by individuals.

In addition to consolidation, section 170 of the bill contains the following substantive changes:

Subsection (b) (1) (A) provides a new special rule which increases the permissible maximum allowable as a deduction by individuals for charitable contributions from 20 percent of adjusted gross income under the 1939 Code to 30 percent under the bill, provided that at least 10 percent of the gifts and contributions are made to organizations specified in clauses (i), (ii), and (iii). It is to be noted that such charitable contribution must be paid *to* the organization and not *for the use of* the organization. Accordingly, payments to a trust (where the beneficiary is an organization described in said clauses (i), (ii), or (iii)) are not included under this special rule.

Under the House bill, the three types of organizations specified in subparagraph (A) are (i) a church, a convention or association of churches, or a religious order; (ii) an educational organization referred to in section 503 (b) (2) of the bill; and (iii) a hospital referred to in section 503 (b) (5). Your committee has amended subdivision (i) by striking the words "or a religious order". Your committee understands that church to some denominations includes religious orders as well as other organizations which, as integral parts of the church, are engaged in carrying out the functions of the church whether as civil law corporations or otherwise. It is believed that the term "church" should be all inclusive. To retain the phrase "or a religious order" in this section of the bill will tend to limit the term and may lead to confusion in the interpretation of other provisions of the bill relating to a church, a convention or association of churches. Accordingly, your committee believes that the section of the bill will be clarified by this amendment.

The term "hospital" in subdivision (iii) does not include medical education and research organizations referred to in section 503 (b) (5).

The general rule of 20-percent limitation on charitable contributions by individuals under existing law is provided in subsection (b) (1) (B). However, for the purpose of computing the limitation of 20 percent of the individual's adjusted gross income, there shall not be taken into account any amount allowed as a deduction under the special rule of subparagraph (A). Thus, the new maximum for charitable contributions by individuals may be 30 percent as contrasted with 20 percent under the 1939 Code. For example, if an individual pays a charitable contribution amounting to 10 percent of his adjusted gross income to an educational organization described in clause (ii) of subsection (b) (1) (A), and also pays a charitable contribution amounting to 20 percent of his adjusted gross income to an organization qualifying under subsection (c), such individual will be allowed a deduction totaling 30 percent of his adjusted gross income.

In the case where an individual pays charitable contributions to organizations specified in subsection (b) (1) (A) in excess of 10 percent of his adjusted gross income, such excess shall be taken into account and allowed as a deduction subject to the general limitation of 20 percent. For example, if an individual pays a charitable contribution of $2,000 to a university and $1,200 to an organization not described in subsection (b) (1) (A), and if such individual's adjusted gross income is $10,000, then the deduction allowed under section 170 (a) would be $3,000. The first $1,000 paid to the university is allowed under the special rule of limitation of subparagraph (A). However, the second $1,000 is taken into account under subparagraph (B) with the $1,200 paid to the organization not described in subparagraph (A); by applying the 20-percent limitation of subparagraph (B), only $2,000 of the $2,200 is allowed as a deduction.

Your committee has slightly revised the wording of section 170 (b) (1) (A) to insure that the additional contributions allowable under that subparagraph may not *in the aggregate* exceed 10 percent of the taxpayer's adjusted gross income, and to eliminate any possible construction which would permit a deduction (over and above the 20 percent allowed under the general limitation) for several contributions to organizations in the special categories to the extent that the contribution to no one church, college, or hospital exceeded 10 percent of adjusted gross income.

Subsection (b) provides that the net operating loss carryback shall not be taken into account in computing (1) adjusted gross income for the purpose of applying the 20-percent limitation upon individuals; (2) adjusted gross income for the purpose of applying the new 10-percent special rule allowing individuals deductions for contributions to specified recipients; (3) taxable income for the purpose of applying the 90-percent rule of unlimited deduction for certain individuals; or (4) taxable income for the purpose of applying the 5-percent limitation upon corporations.

Subparagraph (b) (1) (C) would change the period in which the 90-percent test must be met in order that an individual qualify for unlimited deduction. The period prescribed herein is the taxable year and 8 of the 10 preceding taxable years, as distinguished from the taxable year and each of the 10 preceding taxable years under existing law, and the taxable year and 9 of the 10 preceding years under the House bill.

For the purpose of applying the 5-percent limitation upon corporations, taxable income is computed without regard to (1) special deductions for corporations (secs. 241 to 248), except the deduction for organizational expenditures under section 248, and (2) the special deduction for Western Hemisphere trade corporations (sec. 922), since those deductions were credits against net income under the 1939 code.

Subparagraph (b) (1) (C) provides that the deductions for personal exemptions shall not be taken into account in computing taxable income for the purpose of the 90-percent rule for unlimited deduction. This provision represents no change from section 120 of the 1939 code since the personal exemption is there a credit against net income.

Subparagraph (b) (1) (D) is a new provision added on the floor of the House which denies a deduction for certain charitable contributions or gifts which represent interests in property transferred after March 9, 1954, to a trust. This paragraph operates if the grantor has a reversionary interest in the corpus or income of that portion of the trust with respect to which a deduction would otherwise be allowable and the value of the reversionary interest exceeds 5 percent of the value of the property constituting that portion of the trust. The reversionary interest may consist of a provision requiring the return of the trust corpus to the grantor after a period of time or it may consist of a power exercisable by the grantor or a nonadverse party to revest the property in the grantor at a future date. Thus, if a grantor of a trust transfers $100,000 in trust to pay the income to X University for a period of 5 years and to return the corpus to the grantor or his estate at the end of such term, no deduction under section 170 is allowable with respect to the value of the income interest transferred for the benefit of X University since the value of the grantor's reversionary interest exceeds $5,000 (5 percent of the value of the trust property).

Subsection (c) defines the term "charitable contribution" as a contribution or gift to or for the use of certain public or charitable organizations listed in paragraphs (1) to (4), inclusive. The classifications correspond to those in paragraphs (1), (2), (4), and (5) of section (o) and paragraphs (1), (2), and (3) of section 23 (q). However, certain minor changes are made from existing law in order that obsolete material may be eliminated, clarification attained, and uniformity effected with respect to the types of contributions allowed as deductions by individuals and corporations.

Paragraph (1) of subsection (c) applies to contributions to or for the use of a state, territory, or possession of the United States or any political subdivision thereof, or the United States or the District of Columbia. This provision corresponds to section 23 (o) (1) and section 23 (q) (1) but adds a political subdivision or a possession of the United States as a unit to which a deductible contribution may be made.

Paragraph (2), corresponding to section 23 (o) (2) and 23 (q) (2) of existing law, provides that the term "charitable contribution" includes a gift to or for the use of a corporation, trust, or community chest, fund, or foundation organized and operated for certain specifically listed charitable, etc., purposes. Subparagraph (c) (2) (B) lists among the purposes for which the contribution may be made that of the prevention of cruelty to animals. This is consistent with section 23 (o) (2) applicable to individuals but is not included in section 23 (q) (2) of existing law. Subparagraph (c) (2) (B) also differs from existing law in eliminating the purpose of veterans' rehabilitation services.

Under the House bill subparagraph (c) (2) (B) also provides for the deduction of a contribution to a corporation, trust, community chest, etc., for the benefit of any government referred to in paragraph (1). This provision, which is not contained in existing law, has been omitted by your committee.

Paragraph (3) relates to contributions to a post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization. This provision corresponds to section 23 (o) (4) and section 23 (q) (3) of existing law but provides in explicit terms (not contained in section 23 (o) (4)) that an eligible recipient may be a trust or foundation for posts or organizations of war veterans. A contribution to organizations under this paragraph may have as its purpose the rehabilitation of veterans and qualify for the deduction even though such purpose is eliminated from subparagraph (c) (2) (B).

Your committee has added a new paragraph (5), to permit a deduction for contributions to certain cemetery companies. Such a company must be owned and operated exclusively for the benefit of its members, i. e., lot owners who hold such lots for bona fide burial purposes and not for purposes of resale. Some States permit the incorporation of cemetery companies, and; accordingly, an additional class of cemetery company qualifying hereunder is a corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose.

A corporation will not qualify under this paragraph if any part of its net earnings inure to the benefit of any private shareholder or individual or if it is operated for profit. No company, whether incorporated or not, shall qualify hereunder if its operations or any part thereof are not such as are necessarily incident to burial purposes.

Section 23 (o) (3) of the 1939 Code relating to the special fund for vocational rehabilitation authorized by section 12 of the World War Veterans' Act, 1924 (43 Stat. 611; 38 U. S. C. 440) has been deleted since this fund is no longer in existence, while sections 23 (o) (6) and (q) (4) relating to contributions to the United Nations have been deleted as having expired by their terms on December 2, 1947.

Section 171. Amortizable bond premium

This section corresponds to section 171 of the House bill and to section 125 of the 1939 Code providing a deduction for the amortization of bond premium by the obligee of a bond.

Under existing law the premium may, at the election of the taxpayer, be amortized to maturity, or to the date on which the bond is first callable. Thus, in the case of a $100 bond which is purchased for $110 and which is callable at $105 on 30 days' notice, that part of the premium which represents the difference between the purchase and the call price may be amortized in a single year.

Section 171 (b) (1) (B) of the House bill provides a limitation on the right to amortize the bond premium to the earlier call date. Under this limitation if the earlier call date is a date not more than three years after the date of issuance of the bond the premium must be amortized to the maturity date of the bond rather than to the earlier call date. This provision is made applicable only with respect to bonds issued after January 22, 1951, and acquired by the taxpayer after January 22, 1954.

Your committee has made certain amendments with respect to the limitations contained in the House bill. In the first place the requirement for amortization to maturity is limited to fully taxable bonds so that there is no change from existing law with respect to wholly or partially tax-exempt bonds. In addition, your committee has added an amendment to section 171 (b) (2) relating to the computation of the amortizable bond premium of a particular taxable year. This amendment would have the effect of permitting a taxpayer whose bond falls within the restrictions in the parenthetical portion of section 171

(b) (1) (B) and which is actually called in the taxable year to deduct the remaining unamortized bond premium in the year in which the bond is called. The deduction cannot exceed an amount equal to the excess of the adjusted basis of the bond as of the beginning of the taxable year over the amount received on redemption (or the amount payable on maturity if greater than the redemption price). The effect of this amendment may be illustrated as follows: If a wholly taxable bond issued on January 1, 1954, and acquired by the taxpayer on January 1, 1955, at a price of $109 matures in 10 years from the date of issue (9 years from the date of acquisition) but is callable at $105 on 30 days' notice, section 171 (b) (1) (B) requires that the bond be amortized to maturity, that is, at the rate of $1 per year. If the bond is called on December 31, 1956, for $105 that part of the unamortized premium (exceeding the call price) or $3 ($4 premium paid by the taxpayer less $1 deducted in the year 1955) may be deducted for the year 1956.

Your committee has also amended section 171 (d), containing the definition of a "bond" for purposes of section 171, by eliminating the requirement that the instrument must have attached interest coupons or be in registered form.

The House bill contains two minor changes in subsection (d) (2) relating to the manner and effect of an election to amortize. Section 125 (c) of existing law specifically provides that in the case of a member of a partnership the election with respect to bonds of the partnership shall be exercised only by the partnership. This provision has been eliminated in the bill since it duplicates the general rule with respect to partnership elections contained in section 703 (b). Also, a new provision with respect to the election has been added stating that in the case of bonds held by an estate or trust the election shall be exercisable only by the fiduciary. This rule is implied in section 163 (c) of existing law. Your committee has not made any changes in these provisions of the House bill.

Section 172. Net operating loss deduction

This section corresponds to section 172 of the House bill and relates to the net operating loss deduction. The net operating loss provisions have been rewritten both for purposes of clarity and also to incorporate several major substantive changes.

The first of the substantive changes is to extend the net operating loss carryback from 1 year to 2 years. The House bill makes this change applicable with respect to a net operating loss for any taxable year beginning after December 31, 1953. Your committee recommends that this be changed so that the new provisions will be applicable with respect to a net operating loss for any taxable year ending after December 31, 1953. The present 5-year carryover is retained. As under present law, a net operating loss must first be carried to the earliest year to which such loss may be carried, then to the next earliest year, etc.

The second major change modifies the method of computing the amount of the net operating loss. Under present law, certain adjustments are made in arriving at the amount determined to be the net operating loss. Thus, adjustments are made for any tax-exempt interest received by the taxpayer, the excess of percentage or discovery depletion over cost depletion, the excess of nontrade or nonbusiness deductions of taxpayers other than corporations over gross income from other sources, the excess of capital losses of taxpayers other than corporations over capital gains, and the deduction with respect to long-term capital gains for taxpayers other than corporations. In effect, all these adjustments serve to reduce the amount of the loss which may be carried to another year. Furthermore, in determining the net operating loss for any year, such determination is made without regard to net operating losses of other years.

Under the revised provisions, no adjustment is made with respect to the receipt of tax-exempt interest. Furthermore, your committee recommends that the House bill be amended to provide that no adjustment shall be made with respect to the excess of percentage or discovery depletion over cost depletion. Thus, the receipt of tax-exempt interest will no longer serve to reduce a net operating loss. Similarly, the taxpayer would be allowed to take into account its full deduction for depletion, determined on either the percentage or discovery method, in computing his net operating loss and would not be limited to cost depletion. Furthermore, your committee recommends that the House bill be amended to provide that a corporation shall be allowed to include in its net operating loss the deductions for dividends received by corporations, for dividends received on certain preferred stock of public utilities, for dividends received from certain foreign corporations, and for dividends paid on certain preferred stock of public utilities. Each of these latter deductions is allowed as a credit under present law and is not includible in computing a net operating loss.

Under present law, essentially the same adjustments that are made in computing a net operating loss for a year, with the exception of the one relating to nontrade or nonbusiness expenses, are likewise made in the year to which a loss is carried before such loss may be applied against taxable income. Thus, if a 1953 loss were carried back to 1952 to be applied against 1952 income, any excess of percentage depletion over cost depletion with respect to 1952 in effect would first be used to reduce the 1953 loss carryback before it could be applied as a deduction against 1952 income. In addition, present law provides, in the case of a corporation, for a similar adjustment in the year to which the loss is carried for the dividends-received credit in that year. The loss carryback in effect thus is likewise reduced by the portion of the intercorporate dividends received tax-free before such loss is applied against taxable income. Under the revised provisions, however, no adjustments are made in the year to which the loss is carried prior to computing the amount of the net operating loss deduction. The net operating loss deduction thus will be simply the sum of all the net operating loss carryovers and all the net operating loss carrybacks to the taxable year. Certain adjustments (not including any adjustment for tax-exempt interest or for percentage or for cost depletion) will have to be made, however, in determining the income for any year which must be subtracted from a net operating loss to determine the portion of such loss which will still be available to carry to a subsequent year.

A further substantive change will permit taxpayers other than corporations who sell a business or certain business assets in effect to include any loss sustained on the sale of such business or business assets as part of a net operating loss for the year of the sale. (Corporations are entitled to this treatment under present law and under this section.) Thus, subsection (d) (4) (A) will overrule the decision in *Joseph Sic* v. *Commissioner* (10 T. C. 1096, 177 F. (2d) 649 (CA-8), certiorari denied, 339 U. S. 913), and similar cases, which held, for example, that a farmer who sold his farm at a loss could not include such loss as part of his net operating loss. The cases indicated that such loss was a nonbusiness loss since the taxpayer was not in the business of selling farms. The new provisions will reach the opposite result.

Additional language in the revised section, subsections (d) (3) and (5), has been added to retain the same result as present law in view of the change of personal exemptions and certain corporate credits to deductions.

A new subsection (d) (6) has been added by your committee with respect to the computation of the deduction for dividends received, etc. In computing the net operating loss itself, the deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to the limitation provided in section 246 (b), and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to section 247 (a) (1) (B). In determining the income for any year which must be subtracted from a net operating loss to determine the portion of such loss which will still be available to carry to a subsequent year, however, the deductions allowed by sections 243, 244, and 245 shall be computed by taking into account the limitation provided in section 246 (b) and the deduction allowed by section 247 shall be computed by taking into account section 247 (a) (1) (B).

Your committee has inserted a new subsection (f) with respect to taxable years beginning in 1953 and ending in 1954. The net operating loss for any such taxable year shall not be the amount computed under section 172 (c) but shall be the sum of (1) that portion of the net operating loss for such taxable year computed under section 172 (c) which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such year, and (2) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if section 172 of this bill had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year. The amount of any net operating loss for any such taxable year which shall be carried to the second preceding taxable year shall be the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the income for such second preceding taxable year which must be subtracted from such net operating loss to determine the portion of such loss which will still be available to carry to a subsequent year, such income for such second preceding taxable year shall not exceed the portion of the net operating loss which may be carried to such second preceding taxable year.

In view of the changes made, it was necessary to provide rules as to how net operating losses sustained in taxable years ending after

December 31, 1953, and subsequent years, and the resulting carrybacks, should be computed when carried back to pre-1954 years, and how losses sustained in taxable years ending prior to January 1, 1954, and the resulting carryovers, should be computed when carried over to 1954 and succeeding years. The rules provided in subsection (e) thus indicate that the amount of a loss sustained in the calendar year 1953 shall be computed under the 1939 Code, but adjustments to such loss in 1954 and succeeding years to which the loss which has been so computed is carried shall be made under the 1954 Code. Likewise, the amount of any loss sustained in the calendar year 1954 will be computed under the 1954 Code, but any adjustments to such loss when carried back to 1952 or 1953 will be made under the provisions of the 1939 Code.

Subsection (g) sets forth the transitional rules necessary in determining how many years a loss may be carried back and carried over. Your committee, however, has amended the subsection to conform to the fact that the House bill is applicable with respect to net operating losses for taxable years beginning after December 31, 1953, whereas your committee has recommended that the new provisions be made applicable to net operating losses for taxable years ending after December 31, 1953. Thus, the determination as to how many years a net operating loss sustained in a taxable year ending prior to January 1, 1954, may be carried shall be made under the 1939 Code; such determination for a net operating loss sustained in any taxable year ending after December 31, 1953, shall be made under the 1954 Code. Subsection (g) likewise provides, for example, that in computing the 1952 income which is to be subtracted from a 1954 net operating loss to determine the portion of such loss which may be carried back to 1953 or carried over to a subsequent year, such 1952 income shall be either the amount computed under the provisions of the 1939 Code or the portion of the 1954 net operating loss which may be carried back to 1952, whichever of such amounts is the smaller.

Finally, subsection (g) (3) in effect provides that the substantive changes previously noted shall not affect the excess-profits tax. For example, a net operating loss sustained in 1954 will affect only 1953 so far as the excess-profits tax is concerned, but will have no effect on the 1952 excess-profits tax. A 1954 loss will be computed and adjusted for excess-profits tax purposes as if no changes had been made by this section and as if section 122 of the 1939 Code continued to apply to taxable years ending after December 31, 1953. A loss sustained in 1955 will have no effect whatever on the excess-profits tax.

Section 173. Circulation expenditures

This section corresponds to section 173 of the House bill and to section 23 (bb) of the 1939 Code. In the House bill, the section was rearranged and reworded but no change of substance was intended (H. Rept. 1337, p. A57). However, in order to avoid any possible question as to the substantive effect of the rearrangement, your committee's amendment would substitute the provisions of existing law.

Section 174. Research and experimental expenditures

This section corresponds to section 174 of the bill as it passed the House. It is a new provision relating to research and experimental expenditures paid or incurred in taxable years beginning after December 31, 1953. A taxpayer may (1) treat such expenditures as deductible expenses under subsection (a), or (2) elect to capitalize such expenditures and take advantage of the amortization provisions of subsection (b).

Of course, a taxpayer who does not elect to treat research and experimental expenditures under the methods provided for in this section may capitalize the full amounts thereof.

Subsection (a) provides the general rule that research and experimental expenditures paid or incurred during the taxable year in connection with a trade or business may be treated as expenses not chargeable to capital account and deducted in such taxable year. A taxpayer may adopt this method for treating research and experimental expenditures without the consent of the Secretary for the first taxable year in which such expenditures are paid or incurred and which begins after December 31, 1953, and ends after the date on which this bill is enacted. He may adopt this method at any time with consent.

Once adopted, the method must be adhered to for the taxable year and for all subsequent taxable years unless a change to a different method is authorized by the Secretary or his delegate with respect to part or all of such expenditures. Although a taxpayer may have adopted the method of treating research and experimental expenditures as expenses, he may request an authorization to capitalize research and experimental expenditures attributable to a special project. Such capitalized expenditures would be depreciable over the determinable useful life of the property or amortizable under subsection (b). The authorization with respect to the special project would not affect the method adopted with respect to the taxpayer's regularly incurred research and experimental expenditures.

Subsection (b) provides for the amortization of research and experimental expenditures paid or incurred in connection with the taxpayer's trade or business which are capitalized and not treated as expenses under subsection (a). If the property resulting from the research and experimental expenditures has no determinable useful life, subsection (b) permits the amortization of such expenditures over a period of not less than 60 months as selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). If the property resulting from the research and experimental expenditures has a determinable useful life, subsection (b) is inapplicable and the capitalized expenditures must be amortized over such determinable useful life. The committee amendment to this subsection is to make it clear that the expenditures treated as deferred expenses are to be added to the basis of the property under section 1016 (a) (1). (See sec. 1016 (a) (14) for subtractions from basis on account of amounts allowable as deductions as deferred expenses under sec. 174 (b)).

The election to treat research and experimental expenditures as deferred expenses and to amortize them may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed for filing the return for the taxable year (including extensions thereof) in which the expenditures are paid or incurred. Once elected, the method and the period selected by the taxpayer must be adhered to for the taxable year for which the election is made and for all subsequent taxable years unless a change to a different method (or to a different period) is authorized with respect to part or all of the research and experimental expenditures by the Secretary or his delegate.

Subsection (c) excludes from the applicability of the methods provided in subsections (a) and (b) any expenditure for the acquisition or improvement of land, or for the acquisition of property to be used in connection with the research and experimentation and of a character which is subject to the allowance for depreciation, etc. (sec. 167) or the allowance for depletion (sec. 611). However, such allowances under sections 167 and 611 shall be considered as research and experimental expenditures which may be deducted under subsection (a) or amortized under subsection (b).

Subsection (d) further excludes from the application of this section any expenditure for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, other mineral, oil, or gas. The treatment of such expenditures excluded from the application of this section is subject to determination under other applicable provisions of the bill which are substantially the same as existing law.

Section 175. Soil and water conservation expenditures

This section, which corresponds to section 175 of the House bill, is intended to provide statutory rules under which taxpayers engaged in the business of farming may deduct certain expenditures for the purpose of soil or water conservation in respect of land used in farming or for the prevention of erosion of land used in farming.

Subsection (a), like the comparable section of the House bill, states the general rule that such expenditures, as later defined, may be treated as expenses not chargeable to capital account and, under such treatment, shall be allowed as a deduction. Your committee has added language to make clear that the intent is to allow deductions only where the expenditures for soil and water conservation and for the prevention of erosion of land are made in respect of land used in farming.

Subsection (b) provides a limitation on the amount of such expenditures otherwise deductible. This limitation prevents the deduction in any one taxable year from exceeding 25 percent of the gross income derived from farming during the taxable year. Any excess over the 25 percent figure will, however, be deductible in succeeding years in order of time, subject always, however, to the 25-percent limitation in any later taxable year. The amounts so carried over may be continued without limit in time until used up. In any single succeeding taxable year any amounts carried from preceding taxable years, applying the earliest year first, will be first deductible in arriving at the 25-percent limitation for such year prior to deduction of any amount expended during such year.

The House bill contained a provision (subsec. (b) (2)) which required any amount in excess of the 25-percent limitation to be added to basis, with a reducing adjustment made in any succeeding taxable year in which some part of the carryover was permitted as a deduction under subsection (b) (1). Your committee has omitted this provision as requiring unnecessarily complicated records, so that under the bill as amended a taxpayer electing the benefits of this section will never adjust basis as a result of expenditures for soil and water conservation deductible under the section. Of course, any amount allowable as a deduction under this section, either in the year of expenditure or in a year to which carried, in a year producing a net operating loss will become a part of the loss and be eligible to be carried back 2 years and forward 5.

The phrase "gross income from farming" means the gross income of the taxpayer from the production of crops, fruits or other agricultural products or from livestock and includes such income from a farm other than the one on which expenditures for soil and water conservation or for the prevention of erosion.

Subsection (c) defines certain of the terms used in the section. Subsection (c) (1) defines the term "expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming." Under the definition, the term means expenditures (*a*) for the treatment or moving of earth, including but not limited to leveling, grading, terracing, contour furrowing; (*b*) the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; (*c*) the eradication of brush; and (*d*) the planting of windbreaks. Your committee has modified the language of the House bill slightly to make clear that the words "construction, control, and protection" govern all the types of activities enumerated thereafter in that phrase.

Subsection (c) (1) also makes it clear that expenditures for the purchase, construction, installation, or improvement of structures, appliances or facilities which are of a character subject to the allowance for depreciation, may not be deducted under this section. Language added by your committee makes certain that expenditures for earthen dams, if such items are not depreciable, may be deductible under section 175. Subsection (c) (1) also denies the benefit of the section to any amount which would be allowable as a deduction under any other section of the law.

Your committee has also added language which will make deductible under the section any expenditure to satisfy any part of an assessment levied by a soil or water conservation district in order to defray expenditures made by such district. This provision is to apply only to such portion of such an expenditure by the taxpayer as is not allowable as a deduction under any other section and which defrays expenditures by such a district which, if made by the taxpayer, would constitute an allowable deduction under the section. Thus, such a district may levy an assessment of $1,000 during the taxable year which represents the taxpayer's allocable share of expenditures made by the district in the following proportions: $500 for digging of natural drainage ditches, $250 for amounts otherwise deductible under section 164 (b) (5) and $250 for the acquisition of depreciable assets. If the taxpayer paid such an assessment during the year, only the first $500 noted above would be deductible. Thus, if a taxpayer is assessed $1,000 during the taxable year by the district and pays such an amount, only $250 would be deductible by the taxpayer under this section if $500 of the $1,000 was used by the district to purchase a depreciable building and $250 represented amounts otherwise deductible under section 164 (b) (5).

Subsection (c) (2) defines the term "land used in farming" to mean land used (before or simultaneously with the expenditures for soil and water conservation or the prevention of erosion of land) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

Subsection (d) provides the time when the taxpayer may adopt the expensing of expenditures for the prevention of erosion of land or for soil and water conservation. Under subsection (d) (1) a taxpayer may adopt, without the consent of the Secretary, the method of expensing such amounts as is provided in the section for his first taxable year which begins after 1953 and ends after the date of enactment and during which year he has expenditures for such purposes which are paid or incurred. Subsection (d) (2) provides that irrespective of paragraph (1), a taxpayer may adopt the method of treatment provided in the section at any time, so long as he obtains the consent of the Secretary.

Subsection (e) provides that once a taxpayer has adopted the method provided in the section for the treatment of such expenditures, all such expenditures made by him shall be so treated. It also provides that the method so adopted shall be adhered to by the taxpayer for the taxable year of adoption and for all subsequent taxable years, unless a change to a different method with respect to a part or all of such expenditures is approved by the Secretary.

Part VII—Additional Itemized Deductions for Individuals

Section 211. Allowance of deductions

This section is identical with section 211 of the bill as it passed the House. It provides that in computing taxable income under section 63 (a) (relating to the general definition of "taxable income") the items specified in part VII (relating to additional itemized deductions for individuals), subject to the exceptions provided in part IX (relating to items not deductible), shall be allowed as deductions.

Section 212. Expenses for production of income

This section is identical with section 212 of the bill as it passed the House. It provides that an individual who has elected to itemize his deductions shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income, (2) for the management, conservation, or maintenance of property held for the production of income, or, (3) in connection with the determination, collection, or refund of any tax. Paragraphs (1) and (2) correspond to section 23 (a) (2) of the 1939 code and no substantive change is made.

Paragraph (3) is new and is designed to permit the deduction by an individual of legal and other expenses paid or incurred in connection with a contested tax liability, whether the contest be Federal, State, or municipal taxes, or whether the tax be income, estate, gift, property, and so forth. Any expenses incurred in contesting any liability collected as a tax or as a part of the tax will be deductible.

Section 213. Medical, dental, etc., expenses

This section, authorizing a deduction for extraordinary medical expenses in the case of a taxpayer who elects to itemize his deductions, except for clerical corrections, corresponds to section 213 of the bill as it passed the House. It has been changed from present law in several respects.

Under present law a taxpayer is allowed to deduct (except in the case of a taxpayer who has attained the age of 65 years or whose spouse has attained such age) only the expenses paid which are in excess of 5 percent of adjusted gross income. The bill reduces the percentage requirement to 3 percent of adjusted gross income. However, in computing the amount paid during the taxable year for medicine and drugs, the taxpayer shall take into account only the aggregate of such amounts paid in excess of 1 percent of adjusted gross income.

Under this section, a taxpayer with an adjusted gross income of $6,000, who paid a doctor $300, a hospital $100, and also spent $100 on drugs will compute his medical deduction as follows:

Expenditures for drugs taken into account only to the extent they exceed $60 (1 percent of adjusted gross income), or $40; total medical expenses taken into account $300 plus $100 plus $40 or $440; deductible amount, excess of 3 percent of adjusted gross income or $260. While some question has been raised under present law by taxpayers as to whether the expenditures for toiletries and sundry items may be taken into account this provision makes it clear that expenditures for medicine and drugs (whether or not requiring a prescription) are taken into account but expenditures for toiletries and sundries are not. Only expenditures in excess of the minimum will be included.

Under existing law the maximum deduction allowable for medical expenses is $1,250, multiplied by the number of exemptions allowed (exclusive of the additional exemptions allowed in the case of individuals who are 65 years of age or blind), with a maximum deduction of $2,500; except in the case where a joint return is filed, the maximum deduction is $5,000. The bill would double the maximum deduction allowable for medical expenses and include in the rule with respect to a joint return, a return filed by the head of a household.

Subsection (d) amends existing law and provides that expenses for the medical care of the decedent paid out of his estate within 1 year from the date of his death shall be treated as paid by the decedent at the time the expenses were incurred. This provision permits, upon payment of such expenses by the estate within 1 year from the date of decedent's death, the deduction of the amounts paid in the year in which they were incurred by the decedent. While in the normal case this will be in the taxable year for which decedent's last return is filed, it will also permit the amendment of a prior return to the extent permitted by the statute of limitations. However, the deduction granted in this subsection is not permitted where the amount so paid is also allowable in computing the net estate of the decedent for estate-tax purposes unless a statement is filed that the deduction has not been claimed or allowed for estate-tax purposes together with a waiver of the right to claim such as an estate-tax deduction.

Subsection (e) defines medical care to mean amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of diseases or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or for transportation primarily for and essential to medical care. The deduction permitted for "transportation primarily for and essential to medical care" clarifies existing law in that it specifically excludes deduction of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments and to escape unfavorable climatic conditions which have proven injurious to the health of the taxpayer, and the travel is prescribed for reasons other than the general improvement of a patient's health, the cost of the patient's transportation to Florida would be deductible but not his living expenses while there. However, if a doctor prescribed an appendectomy and the taxpayer chose to go to Florida for the operation not even his transportation costs would be deductible. The subsection is not intended otherwise to change the existing definitions of medical care, to deny the cost of ordinary ambulance transportation nor to deny the cost of food or lodging provided as part of a hospital bill.

Subsection (f) provides that any expense relating to child care allowed as a deduction under section 214 shall not be treated as an expense paid for medical care.

Section 214. Expenses of care of certain dependents

Your committee has revised section 214 of the House bill to provide for a deduction for all workingwomen and for widowers for the care of certain dependents.

This section provides a deduction (not to exceed $600 for any taxable year) for expenses of care of certain dependents which are paid for the purpose of permitting a taxpayer to be gainfully employed (including self-employed).

In order to qualify for this deduction the taxpayer must be either (1) a woman or (2) a widower. Widower is defined in the usual way as a man whose spouse has died and who has not remarried. The term also includes a married man who is legally separated from his spouse under a decree of divorce or of separate maintenance. This deduction is allowed for the care of a child who is a son, daughter, or stepchild of the taxpayer as defined in section 152 under the age of 12, or for a dependent, as defined in section 152, for whom the taxpayer is entitled to a deduction under section 151 (e) (1), who is physically or mentally incapable of caring for himself. Only those expenses will be allowed which are incurred for care prior to the time the child reached the age of 12. For example: If a child's 12th birthday is on July 1, 1955, the parent, otherwise qualified, may deduct such child-care expenses paid during the taxable year (not to exceed the maximum limitation) as are incurred up to July 1, but may not deduct those expenses for child care incurred after July 1.

The deduction is limited to $600 regardless of the number of qualified dependents. Thus the deduction may never be greater than $600 but may be less depending on the actual amount spent. There may be no deduction for amounts paid to a person for whom the taxpayer is allowed a dependency deduction for the taxable year under section 151.

In order to claim this deduction a woman who is married must file a joint return with her husband. A woman is not to be considered as married if she is legally separated from her husband under a decree of divorce or of separate maintenance. The deduction for a married woman will be reduced by the amount (if any) which the adjusted gross income of the taxpayer and her spouse exceeds $4,500. Thus, if a woman and her husband have an adjusted gross income of $4,700 the deduction may not exceed $400 ($600—($4,700—$4,500)=$400). These two limitations (joint return and income) will not apply where the taxpayer's husband is incapable of self-support because mentally or physically defective.

Deduction for the expenses of care of qualified dependents will be allowed only for those periods in which the taxpayer is gainfully employed or in active search of gainful employment. If the taxpayer has a child in a nursery school which costs $50 per month and the taxpayer is only employed for 2 months during the year, the taxpayer may only deduct $100 as child-care expenses. If the taxpayer was employed for only 2 weeks in each of 2 months she could only deduct that proportion that the child-care expenses allocable to those periods during which she was working. Also, if the taxpayer is employed for only one-half a day but has the child cared for all day, only that proportion of the expenses as are incurred to allow the taxpayer to be gainfully employed will be allowed. In this case only one-half of the expenses will be allowed.

If the taxpayer has a maid or housekeeper who cares for the children (or other qualified dependents) in addition to her other household duties of cleaning and cooking, the cost of the maid's salary must be prorated and only that portion which is allocable to child (or other qualified dependents) care may be taken as a deduction. Assume, for example, that W, a widow, has a maid, M, who cares for her two children (one 5 years old, the other 14) in addition to cleaning the house and cooking meals. Assume that 50 percent of the maid's time is spent in caring for the children. W pays the maid $25 per week and is herself employed for the full year. Of the $1,300 paid to the maid, only $600 will be allowed as a deduction for child care. This amount is arrived at by dividing the $1,300 by 2 to determine the amount spent for child care, the result in this case is $650. The maximum allowed for child-care expense deduction is $600, hence, W has a $600 child-care deduction. It will be noted that the amount allocated to child care, will not be further allocated between the children under 12 years of age and those over that age.

Section 215. Alimony, etc., payments

This section, which is identical with section 215 of the bill as it passed the House, is substantially the same as existing law, except for the changes necessary to correlate with section 71 of this bill.

Section 216. Amount representing taxes and interest paid to cooperative housing corporation

This section, which is identical with section 216 of the bill as it passed the House, reenacts, in revised form, section 23 (z) of the 1939 Code by allowing as a deduction not otherwise deductible to each stockholder an amount representing his proportionate share of the total amount of taxes and interest paid to a cooperative apartment corporation. The only substantive change is that the benefits of the section are also granted to stockholders of any cooperative housing corporation meeting the tests of the section.

Section 217. Cross references

This section is identical with section 217 of the bill as it passed the House.

Part VIII—Special Deductions for Corporations

Section 241. Allowance of special deductions

This section is identical with section 241 of the bill as it passed the House. It provides that in addition to the deductions provided in part VI (sec. 101 and following) there shall be allowed as deductions to corporations in computing taxable income the items specified in part VIII.

Section 242. Partially tax-exempt interest

This section, which is identical with section 242 of the bill as it passed the House, corresponds to section 26 (a) of the 1939 Code. The only change is to convert the credit provided in that section of the Code into a deduction.

Section 243. Dividends received by corporations

This section, which is identical with section 243 of the bill as it passed the House, corresponds to section 26 (b) (1) of the 1939 Code.

Under existing law, a corporation in general is entitled to a credit against net income of 85 percent of the amount received as dividends (other than dividends on certain preferred stock of public utility companies) which it receives from other domestic corporations which are subject to tax. Subsection (a) of this section continues this treatment but provides that the shareholder corporation will be allowed a deduction instead of a credit.

Subsection (b) of the section provides special rules for certain types of corporate distributions. These rules are correlated with those applicable in the case of the dividends-received credit under section 34 for dividends received by individuals. As under existing law, a dividend paid by a mutual savings bank for which the bank is allowed a deduction under section 591 (dividends paid to depositors which are in the nature of interest) is not treated as a dividend for which the dividends-received reduction is allowable. Also, a dividend received from a regulated investment company is subject to the limitations prescribed in the sections dealing with the taxation of such companies.

Section 244. Dividends received on certain preferred stock

This section, which is identical with section 244 of the bill as it passed the House, accomplishes the same purpose as section 26 (b) (2) of the 1939 Code. Under present law, dividends received on certain preferred stock of a public utility company qualify for a dividends-received credit to the extent of the portion of the dividend not allowed as a credit to the payor corporation. Under the present method of computation any change in corporate tax rates makes it necessary to compute a new percentage each time so as, in effect, to give approximately a 14 percentage point tax benefit.

In addition to changing the credit to a deduction, this section establishes a formula which will automatically provide the correct percentage for a deduction for dividends received on preferred stock of a public utility regardless of changes in tax rates. This percentage is geared to the deduction provided in section 247 for the payment of dividends on certain preferred stock of public utility companies. This section does not make any substantive change in present law.

Section 245. Dividends received from certain foreign corporations

This section corresponds to section 245 of the House bill and to section 26 (b) (3) of the 1939 Code, which provides a credit for dividends received from certain foreign corporations. The House bill changes the credit to a deduction and provides that the deduction will be keyed to the percent provided in section 243 for the taxable year in computing the deduction for dividends received by corporations.

Your committee has retained the House provision but with necessary amendments in the cross references to other provisions of the bill.

Section 246. Rules applying to deductions for dividends received

This section corresponds to section 246 of the House bill.

Subsection (a) of section 246 provides that the deductions allowed by sections 243, 244, and 245 (relating to deductions for dividends received) shall not apply to dividends received from certain types of corporations. Under the House bill, no such deduction shall be allowed with respect to any dividend received from (1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following); (2) a corporation organized under the China Trade Act, 1922 (see sec, 941); (3) a corporation which, for the taxable year of the distributing corporation in which the distribution is made, or for the next preceding taxable year of such corporation, is a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or (4) a corporation which, for the taxable year of the distributing corporation in which the distribution is made, or for the next preceding taxable year of such corporation, is a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

Under your committee's amendment the disallowance of the deduction set forth in subsection (a) (1), to insurance companies, has been eliminated so that the deduction applies to dividends paid by such companies to corporate shareholders as under existing law.

Subsection (b) of section 246 provides a limitation on the aggregate amount of the deductions allowed by sections 243, 244, and 245 (relating to deductions for dividends received). Under the House bill, the aggregate of such deductions is not to exceed 85 percent of the taxable income of the shareholder corporation computed without regard to the deductions allowed by sections 172, 243, 244, 245, or 247. Under your committee's amendment, the provision of the House bill is retained in paragraph (1) of subsection (b) as the general rule. A new paragraph (2), however, has been added to subsection (b). This new paragraph (2) in effect provides that if the shareholder corporation has a net operating loss, as determined under section 172, for any taxable year, then the deductions provided in sections 243, 244, and 245 shall be allowable for all tax purposes to such shareholder corporation for such taxable year without regard to the limitation provided in paragraph (1) of subsection (b). If the shareholder corporation does not have a net operating loss for a given taxable year, however, the limitation provided in paragraph (1) of subsection (b) will be applicable for all tax purposes for such taxable year. It is to be noted that in determining whether the shareholder corporation has a net operating loss for a taxable year under section 172 the deductions allowed by sections 243, 244, and 245 are to be computed without regard to any limitation provided in section 246 (b).

Section 247. Dividends paid on certain preferred stock of public utilities

This section corresponds to section 247 of the House bill and to section 26 (h) of the 1939 Code.

The House bill changes the credit provided in section 26 (h) to a deduction. In addition it establishes a formula so that this deduction with respect to dividends paid on certain preferred stock of public utility companies will automatically be determined, based upon the corporate normal and surtax rates for the particular taxable year. It will no longer be necessary to change the statute with respect to this deduction merely because the tax rates are changed.

This section does not make any substantive changes in existing law.

Clerical changes in the references to other provisions of the bill are made in the amendments of your committee to the House bill.

Section 248. Organizational expenditures

This section is identical with section 248 of the House bill.

This is a new provision which would permit the organizational expenditures of a corporation to be treated as deferred expenses at the election of the corporation.

If such election is made, the deferred expenses will be allowed as a deduction in computing taxable income ratably over a period of 60 months or more as selected by the taxpayer. The period over which such expenses can be spread will begin with the month in which the corporation begins business.

Organizational expenditures are those expenditures which are directly incident to the creation of the corporation. In this category would be included expenditures for legal services to obtain the corporate charter, fees paid to the State of incorporation, expenses of temporary directors of the corporation, etc. Expenditures connected with the reorganization of a corporation unless incident to the creation of a corporation, and hence are not subject to the provisions of section 248.

Further limitations upon the expenditures to which this section is applicable are that the expenditures must be of a character which are chargeable to capital account and which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. 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. Such expenses are not organizational expenditures within the meaning of section 248, even where the particular issue of stock to which the expenses relate is for a fixed term of years. The case of *Surety Finance Company of Tacoma* v. *Commissioner* (77 F. (2d) 221), demonstrates that expenses incurred in connection with the sale of stock are not of the character to be amortizable over the limited life of a corporation.

Under subsection (c) of this section, the corporation may elect the new treatment for any taxable year beginning after December 31, 1953, but only if such election is made not later than the time prescribed for filing the return for such taxable year (including any extensions of time). After any such election organizational expenditures must be treated as deferred expenses and the period of 60 months or more (which must be selected at the time of such election) must be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years.

The election shall apply only with respect to expenditures paid or incurred on or after the date of enactment of this title.

PART IX—ITEMS NOT DEDUCTIBLE

Section 261. General rule for disallowance of deductions

This section, which is identical with section 261 of the bill as it passed the House, corresponds to section 24 (a) of the 1939 Code. No substantive change is made.

Section 262. Personal, living, and family expenses

This section, which is identical with section 262 of the bill as it passed the House, corresponds to section 24 (a) (1) of the 1939 Code. No substantive change is made.

Section 263. Capital expenditures

This section corresponds to section 263 of the House bill.

Subsection (a) of the House bill corresponds to section 24 (a) (2) and 24 (a) (3) of the 1939 code. In addition subsection (a) of the House bill includes provisions for research and experimental expenditures under section 174 and for soil and water conservation expenditures under section 175. Subsection (b) of the House bill corresponds to section 23 (a) (1) (C) of the 1939 code and no substantive change is made in that provision.

A new subsection (c) has been added by your committee to provide that the provisions of subsection (a) will not apply to intangible drilling and development costs in the case of oil and gas wells insofar as these expenditures are deducted as expenses under regulations prescribed by the Secretary or his delegate under this subtitle corresponding to regulations under the 1939 code which were recognized and approved by the Congress in House Concurrent Resolution 50, 79th Congress.

Section 264. Certain amounts paid in connection with insurance contracts

This section corresponds to section 264 of the House bill. The only change made by your committee is to limit to prospective application the denial of an interest deduction in certain cases not covered by existing law.

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 within 4 years from the date the contract is 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. Under the bill the same treatment will be extended to such indebtedness as indebtedness incurred to purchase single-premium life-insurance or endowment contracts. The denial of the deduction, however, applies only as to annuities purchased after March 1, 1954.

The House bill also provides for the denial of the interest deduction where, in lieu of the payment of a substantial number of premiums within 4 years from the date of the contract, the purchaser deposits borrowed funds with the insurance company for payment of future premiums on the bond. While, under the House bill, this provision was applicable to amounts deposited in the past, your committee would make this provision applicable only to amounts deposited after March 1, 1954, in the same manner as in the case of annuity contracts.

Section 265. Expenses and interest relating to tax-exempt income

This section is identical with section 265 of the bill as it passed the House.

Subsection (a) is the same as section 24 (a) (5) of the 1939 Code. Subsection (b) contains the same rule as section 23 (b) of the 1939 Code. No substantive changes are made in either of these provisions.

Section 266. Carrying charges

This section is identical with section 266 of the bill as it passed the House. It is the same as section 24 (a) (7) of the 1939 Code. No substantive change is made.

Section 267. Losses, expenses, and interest with respect to transactions between related taxpayers

This section is identical with section 267 of the bill as it passed the House.

Subsection (a) continues the disallowance of losses from sales or exchanges between certain related taxpayers and the disallowance of certain unpaid expenses and interest contained in subsections (b) and (c), respectively, of section 24 of the 1939 Code. In the enumeration of related taxpayers in subsection (b) three additional classes have been added: (1) A fiduciary of one trust and a beneficiary of another trust if the same person is grantor of both (paragraph (7)); (2) a fiduciary of a trust and a corporation more than 50 percent owned by or for the trust or by or for a person who is a grantor of the trust (paragraph (8)); and (3) a person and an exempt organization controlled by the person or his family, if the person is an individual (paragraph (9)). Paragraph (8) would change the result in the *Snively* case (20 T. C. No. 18 (1953)) and the *Lexmont* case (20 T. C. No. 22 (1953)). In *Snively*, the transaction was between a corporation more than 50 percent of the value of the stock of which was owned by taxpayer and a trust established by his children. Under the constructive ownership rule of subsection (c) (2), a son or daughter would be treated as owning the stock owned by the father, and the transaction is thus between a fiduciary of a trust and a corporation more than 50 percent owned by a grantor of the trust. In *Lexmont*, the transaction involved a trust and a corporation which was 100 percent owned by the trust.

Control includes any kind of control, direct or indirect, whether legally enforcible, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise.

Subsection (c) continues the constructive ownership rules to be used in determining whether or not taxpayers are related for purposes of subsection (b).

Subsection (d) provides a new rule for recognition of gain on the disposition of property if a loss incurred by the transferor on the transfer of the property to the taxpayer had not been allowable by reason of subsection (a) (or sec. 24 (b) of the 1939 Code). Any gain to the taxpayer on the disposition of the property will be recognized only to the extent that it exceeds the amount of the loss not previously allowable. This rule does not affect the basis of the property for determining gain, and consequently depreciation and other items which depend upon that basis are also unaffected. The holding period of the taxpayer will be determined without regard to section 1223.

The benefit of the provision is limited to the original transferee. If the property is given away the donee does not come within the terms of the provision. If, however, the property is disposed of in a transaction in which other property is received, the basis of which is determined by reference to the basis of the original property, subsection (d) is applicable to reduce the amount of gain to be recognized on a future disposition by the taxpayer of the other property. Similarly subsection (d) applies to a disposition of property held after a series of transactions if the basis of the property acquired in each is determined by reference to the property transferred, and the original property was acquired in a transaction in which a loss of a transferor was not allowable under subsection (a) (or sec. 24 (b) of the 1939 Code).

If property received in a transaction in which a loss of the transferor is not allowable under subsection (a) (or sec. 24 (b) of the 1939 Code), consists of divisible property or several items or classes of items, determination of the basis of the taxpayer in each part, item, or class (if necessary) is made by an allocation among the property received, in the proportion that the fair market value of each bears to the fair market value of all such property at the time that the property is received. If the taxpayer disposes of a portion of the property received at a price in excess of basis, the amount of the gain which is not recognized by reason of subsection (d) (i. e., the loss not previously allowable) must be determined. The loss not previously allowable is the difference between the adjusted basis of the property for determining loss in the hands of the transferor and the portion of the purchase price properly allocable to the property. However, if it cannot be established that, in a tax computation, the transferor has used the basis of the property now being disposed of by the taxpayer or any other part of the property transferred by the transferor, the portion of the loss properly allocable to the property is that part of the total loss which was not allowable to the transferor which the value, at the time of receipt by the taxpayer, of the portion of the property being disposed of bears to the value, at the time of receipt by the taxpayer, of all the property received in the transaction to which subsection (a) (or sec. 24 (c) of the 1939 Code) applied.

Section 268. Sale of land with unharvested crop

This section, which is identical with section 268 of the bill as it passed the House, corresponds to section 24 (f) of the 1939 Code. No substantive change is made.

Section 269. Acquisitions made to evade or avoid income tax

This section corresponds to section 269 of the House bill.

Subsections (a) and (b) correspond to the provisions of section 129 of the 1939 Code.

Subsection (c) provides a procedural device for the determination of whether the principal purpose of an acquisition specified in subsection (a) (1) or (2) was evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance not otherwise available. Under the House bill this subsection provides that certain factors should be determinative of the principal purpose of evasion or avoidance of Federal income tax unless the taxpayer by a clear preponderance of the evidence should prove to the contrary. This presumption would arise where the consideration paid upon an acquisition is substantially less than the aggregate of—

(1) the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (a) (1)) or of the property acquired specified in paragraph (a) (2); and

(2) the tax benefits (to the extent not reflected in the adjusted basis of the property) not available otherwise than as a result of the acquisition.

Under the amendment made by your committee the fact of the substantially disproportionate consideration is made prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax rather than determinative (subject to rebuttal by a clear preponderance of the evidence) as in the House bill.

Subsection (c) applies only with respect to acquisitions after March 1, 1954.

Section 270. Limitation on deductions allowed to individuals in certain cases

This section corresponds to section 270 of the House bill and to section 130 of the 1939 Code and except as provided by subsection (b), no substantive change is made.

In the House bill subsection (b), specially treated deductions, lists certain deductions which, under subsection (a), will not be included in determining whether the deductions of the taxpayer attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business. In addition to taxes and interest, which are given such treatment under the 1939 Code, casualty and abandonment losses connected with the trade or business, losses and expenses of a trade or business of farming which are directly attributable to drought, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses when incurred, or (2) to defer or capitalize, are added by the House bill as deductions which will be given such special treatment. Your committee's bill further adds to this class of specially treated deductions the net operating loss deduction, but the net operating loss deduction will be specially treated only for purposes of determining whether in any taxable year there is a statutory excess of deductions. If, because there is a statutory excess of deductions (other than specially treated deductions) in each of 5 consecutive years, a recomputation of taxable income is made, the net operating loss deduction will not be allowed. This treatment in a recomputation of the net operating loss deduction is the same under existing law.

Your committee's bill also adds to subsection (a) a provision to make it clear that except for taxes and interest the specially treated deductions shall be so treated only with respect to the taxable years in a period of 5 consecutive taxable years, one or more of which is a taxable year beginning after December 31, 1953. The substantive amendments contained in subsection (b) are therefore retroactive only in respect to taxable years in a not yet completed period of 5 consecutive taxable years.

Section 271. Debts owed by political parties, etc.

This section, which is identical with section 271 of the bill as it passed the House, corresponds to section 23 (k) (6) of the 1939 Code. No substantive change is made.

Section 272. Disposal of coal

This section corresponds to section 272 of the bill as passed by the House. Your committee has made several substantive changes.

Your committee has eliminated subsection (a) of section 272 of the House bill, which provided for the disallowance of certain expenses incurred in connection with the holding and quantity measurement of timber in cases where the cutting of such timber is considered to be a sale or exchange thereof. Also, subsection (b) of section 272 of the House bill, which provided for the disallowance of certain expenditures attributable to disposition of coal or timber where the taxpayer is entitled to capital gains treatment on such disposition, has been amended by your committee so as to be applicable only to coal and to iron ore from deposits in the United States, but not to timber. The amendment with respect to iron ore has been made because your committee has extended the benefits of section 117 (k) (2) of the 1939 Code to iron ore from deposits in the United States.

Section 272, as amended by your committee, provides that where the disposal of coal or iron ore is covered by section 631 (entitling the owner thereof to capital gains treatment upon such disposition), no deduction shall be allowed for expenditures attributable to the making of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that when in any taxable year such expenditures plus the adjusted depletion basis of the coal or iron ore disposed of exceed the amount realized under such contract, such excess, to the extent not used as a reduction of gain under section 1231, shall be a loss deductible under section 165 (a). The expenditures covered by section 272 include such items as the following, to the extent paid by the taxpayer: ad valorem taxes imposed by State or local authorities, costs of fire protection, insurance costs of all kinds relating to the property (not including liability insurance), costs incurred in administering a coal or iron ore lease (including costs of bookkeeping and technical supervision), interest on loans attributable to the coal or iron ore, expenses of flood control, legal and technical expenses attendant to the making of the contract, and the expenses of measuring and checking quantities disposed of under the contract.

Under section 272 the entire amount of such expenses shall be disallowed as a deduction if the taxpayer receives any income under the contract, without regard to the fact that no coal or iron ore may have been disposed of under the contract during that year. If no income is received in the taxable year under the contract, section 272 will not be applicable, and as under present law, such expenses may be deducted from other income as business expenses or, depending upon the application of section 266 to the particular expense, may be capitalized at the election of the taxpayer. If in any taxable year expenditures disallowed by section 272, plus the adjusted depletion basis of the coal or iron ore disposed of, exceed the amount realized, under the contract, such excess, to the extent not availed of as a reduction of gain under section 1231, shall be a loss deductible under section 165 (a).

If the contract under which the coal or iron ore is disposed of is terminated and, although income may have been received under the contract, no coal or iron ore was actually disposed of, an amended return shall be filed for each year in which such income was received, and in the computation of tax for such year, section 272 (b) shall not be applicable. In such case, as under present law, such expenses may be deducted from other income as a business expense, or depending upon the application of section 266 to the particular expense may be capitalized at the election of the taxpayer.

Section 273. Holders of life or terminable interest

This section is identical with section 273 of the House bill.

This section corresponds to section 24 (d) of the 1939 Code. To correlate however with the changes made in the taxation of estates and trusts in subchapter J there has been eliminated the provision of existing law which denies to holders of a life or terminable interest any deduction allowed by the 1939 Code (other than the deduction for depreciation and depletion). Under the new provision for taxation of estates and trusts such deductions are made available to beneficiaries to the extent that they are not used by the estate or trust.

SUBCHAPTER C—CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Part I. Distributions by Corporations

GENERAL

Part I of subchapter C provides rules relating to the tax treatment to shareholders of corporate distributions of property. While your committee continues the treatment provided in the House bill under which part I has no application at the corporate level to distributions of property in complete or partial liquidation, your committee's bill, unlike the House bill, does not include in part I rules for distributions made in connection with corporate reorganizations. Under your committee's bill, distributions and exchanges made in connection with reorganization transactions are treated, in general, in part III.

Subpart A of part I sets forth the effects on shareholders of corporate distributions of property. Under section 301 the general rules are provided for the tax treatment to shareholders of such ordinary distributions. Section 302 treats property distributions made in connection with the redemption of stock. Section 303 sets forth a special rule for redemption of stock to pay death taxes. Section 304 treats as redemptions certain sales of stock made between related corporations. Rules covering the distribution of stock dividends and stock rights appear in section 305. The basis of property to shareholders received in distributions under subpart A is determined under section 307.

Section 306 of your committee's bill is a new section not appearing in the House bill which would provide special treatment for the sale and redemption of certain stock received as a dividend or received in connection with certain reorganization transactions. This section replaces section 309 of the House bill which imposed a transfer tax at the corporate level on certain redemptions of stock. No counterpart to section 309 appears in your committee's bill.

Subpart B of part I enumerates certain consequences to corporations resulting from the distribution of property to its shareholders. Under section 311, the general rule as to taxability of the corporations on such distributions is set forth. Section 312 provides certain of the adjustments to earnings and profits of the distributing corporation which are to be made as a result of a distribution, regardless of the type of transaction in which such distribution is effected to the extent provided therein. Section 316 contains the definition of the term "dividend" which in substance is identical to existing law, and is applicable throughout the subtitle. Section 317 defines the term "property" and describes certain transactions in which a corporation shall be treated as having redeemed its stock within the meaning of part I. Section 318 contains rules which articulate the extent to which ownership of stock by one person shall be attributed to another.

SUBPART A—EFFECTS ON RECIPIENTS

Section 301. Distributions of property

Section 301 continues the provisions of section 301 of the House bill and prescribes the basic rule governing the taxation to a shareholder of corporate distributions of property. This section, as section 301 of the House bill, is derived generally from section 115 (a), (b), (d), (e), (f), and (j) of the 1939 Code.

Subsection (a) of section 301 provides that a distribution of property (as defined in sec. 317 (c)) made by a corporation to a shareholder with respect to his stock shall be treated in the manner provided in subsection (c) of section 301. Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such. For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301.

Subsection (b) sets forth the rules for determination of the amount of any distribution made under section 301. Paragraph (1) of subsection (b) provides the general rule under subparagraph (A) where the shareholder is not a corporation. In such case the amount of any distribution shall be the amount of money received plus the fair market value of the other property received.

Under subparagraph (B) of paragraph (1), if the shareholder is a corporation the amount of any distribution is the amount of money received plus the lesser of (i) the fair market value of the other property received, or (ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received. This latter amount is increased in the amount of gain to the distributing corporation which is recognized under section 311 (b) (relating to distributions of LIFO inventory) or under section 311 (c) (relating to distributions of property subject to a liability in excess of the adjusted basis of such property).

Paragraph (2) of subsection (b) provides that the amount of any distribution (determined under par. (1)) shall be reduced (but not below zero) by (A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution and (B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution, whether or not the distributing corporation remains liable in either case. Thus if an individual shareholder receives a distribution of property from a corporation having a fair market value of $1,000 subject immediately before, and immediately after the distribution, to a liability of $700 the amount of such distribution under subsection (b) will be $300.

Paragraph (3) of subsection (b) provides that for the purposes of section 301, fair market value shall be determined as of the date of the distribution. In this respect, the date on which the property distributed may have become includible in the income of the shareholder is not material to the determination of such fair market value.

Subsection (c) corresponds to section 301 (b) of the House bill and determines in general the extent to which a distribution is taxable as a dividend (subject, however, to the provisions of secs. 34 and 116), applied against the basis of the stock or is taxable to the shareholder as gain from the sale or exchange of property as the case may be.

Paragraph (1) of subsection (c) provides that that portion of the distribution which is a dividend shall be included in gross income. The term "dividend" is defined in section 316.

Paragraph (2) of subsection (c) restating the substance of section 115 (d) and a portion of section 115 (b) of the 1939 code, provides that that portion of the distribution which is not a dividend shall first be applied against and reduce the adjusted basis of the stock.

Paragraph (3) prescribes rules for taxation of that portion of a distribution which is in excess of the basis of the stock. This section corresponds generally to section 115 (d) of the 1939 code.

Subparagraph (A) sets forth the general rule that to the extent that the portion of the distribution which is not a dividend exceeds the adjusted basis of the stock, such portion shall be treated as gain from the sale or exchange of property. Under subparagraph (B), an exception to the rule of subparagraph (A), that portion of the distribution which exceeds the adjusted basis of the stock but which is out of increase in value accrued before March 1, 1913, shall be exempt from tax. While under your committee's bill, as well as under the House bill, no reference is made to earnings and profits accumulated before March 1, 1913, your committee does not intend any change in existing law.

Subsection (d) of section 301 is a new subsection which does not appear in the House bill and for which there is no statutory counterpart under the 1939 Code. This subsection sets forth rules for determination of the basis of property received in a distribution to which subsection (a) applies.

Under paragraph (1) of subsection (d) the basis of such property shall be its fair market value if the shareholder is not a corporation. Under paragraph (2) if the shareholder is a corporation, the basis of such property shall be the lesser of (A) the fair market value of such property or (B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property. Such basis shall be increased in the amount of gain to the distributing corporation which is recognized under section 311 (b) or section 311 (c).

Subsection (e) of section 301 corresponds to section 301 (e) of the House bill and section 115 (e) of the 1939 Code. This subsection relates to exemption from tax of certain distributions made by personal service corporations classified as such under the Revenue Act of 1918 or 1921 and restates existing law under section 115 (e) of the 1939 Code.

Section 302. Distributions in redemption of stock

Section 302 corresponds in function to section 302 of the House bill and relates to section 115 (c), (g), and (i) of the 1939 Code. Under this section, rules are prescribed for the tax treatment to shareholders receiving distributions of property in redemption of stock. As under section 302 of the House bill, distributions in redemption of stock which qualify as distributions in complete or partial liquidations under part II of subchapter C are not within the scope of section 302. Unlike the House bill, however, section 302 does not provide specific statutory guides governing the tax consequences of every stock redemption. In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry. For special rules relating to the redemption of section 306 stock, see the discussion under section 306.

Subsection (a) states the general rule of section 302 whereby it is provided that if a corporation redeems its stock (within the meaning of sec. 317 (b)) and if subsection (b) applies, such redemption shall be treated as a distribution in full or part payment in exchange for the stock.

Subsection (b) of section 302 states three conditions in paragraphs (1), (2), (3), and (4), the satisfaction of any one of which will result in the treatment of the redemption as a distribution in full or part payment in exchange for the stock. In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under section 115 (g) (1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances.

In cases where the distribution in redemption is pursuant to a partial liquidation qualifying under section 346, but an amount in excess of the amount permitted to be distributed in such liquidation is distributed, such excess shall be treated as if received in a redemption to which section 302 applies.

Paragraph (1) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend.

The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115 (g) (1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits. The fact that the proceeds of the redemption are not taxable as ordinary income to X results through application of section 302 (d) and section 301.

Paragraph (2) of subsection (b) sets forth a general rule that if the redemption is substantially disproportionate, it will be treated as a sale under subsection (a), if the other conditions described in the paragraph are met. It is intended that the general rule shall apply with respect to a redemption of preferred stock (other than section 306 stock) as well as common stock.

However, subparagraph (B) limits the application of paragraph (2) by providing that the general rule shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Subparagraph (C) of paragraph (2) defines the term "substantially disproportionate." It is provided that a distribution will be substantially disproportionate with respect to a shareholder only if, the ratio which the voting stock owned by the shareholder after the redemption bears to all the voting stock of the corporation at such time, is less than 80 percent of the ratio which the voting stock owned by the shareholder immediately before the redemption bears to all the voting stock of the corporation at such time. In addition, in order that a distribution may qualify as "substantially disproportionate" it is necessary that the shareholder's ownership of voting or nonvoting common stock (that is, his participating interest) in the corporation also be reduced by the percentage required with respect to voting stock. For this purpose, if there is more than one class of common stock, the determinations shall be made by reference to fair market value. In determining the ownership of stock, subsection (c) makes clear that the rules of constructive ownership provided in section 318 are applicable.

It is intended that the 80 percent rule shall be applied on a share holder-by-shareholder basis, and that the application of the rule to one shareholder shall not affect the application of the rule to any other shareholder.

Subparagraph (D) of paragraph (2) provides that paragraph (2) shall not apply to any redemption which is made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which in the aggregate is not substantially disproportionate with respect to the shareholder. For example: A corporation has, as its sole capitalization, 100 shares of common stock outstanding. Shareholder A owns 55 shares and shareholder B 45 shares. Shareholders A and B are unrelated. In 1955, pursuant to a plan the corpc ation redeems 12 shares of the stock of shareholder A and none from shareholder B. Such redemption standing alone qualifies as a disproportionate redemption within the meaning of section 302 (b) (2). In 1956, pursuant to the plan, the corporation redeems 10 shares of shareholder B's stock and none from shareholder A. This redemption, standing alone, would also have qualified as a disproportionate redemption within the meaning of section 302 (b) (2). However when the two transactions are reviewed together it is apparent that shareholders A and B have not sufficiently changed their respective proportionate interests in the corporation. Accordingly, under the rule of subparagraph (D), both redemptions would fail to qualify as substantially disporportionate.

Paragraph (3) (relating to termination of a shareholder's interest) corresponds to section 302 (a) (3) of the House bill by providing that a distribution which is in complete redemption of all of the stock of a corporation owned by a shareholder shall be treated as a distribution in full payment for the stock of such shareholder. This paragraph must be read in connection with the provisions of subsection (c) of section 302 relating to constructive ownership of stock.

Paragraph (4) provides that subsection (a) shall apply if the redemption is of stock issued by a railroad corporation (as defined in section 77 (m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

Paragraph (5) describes the interrelationship of paragraphs (1) through (4), and is intended to make clear that if a redemption meets the requirements of paragraph (1) as not essentially equivalent to a dividend, the fact that such redemption fails to qualify under paragraphs (2), (3), and (4), shall not be taken into account. Under such circumstances such redemption would remain qualified under paragraph (1) and be taxed under subsection (a). Similarly, if a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c) (2) as would apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

Subsection (c) of section 302, which corresponds in general to section 302 (c) of the House bill, provides rules for determination of the constructive ownership of stock for the purpose of section 302.

Paragraph (1) provides that the rules for constructive ownership of stock of section 318 (a) shall apply for purposes of this section generally. For example, if an individual owns half of the stock of a corporation, and a trust of which such individual is the sole beneficiary, owns the other half of such stock, a redemption of all of the stock of the corporation owned individually would not qualify under paragraph (2) or (3) of subsection (b). Under these circumstances, by reason of the application of section 318 (a) (2) (B), such individual would, be considered as owning all of the stock of the corporation, both before and after the redemption.

Paragraph (2) of subsection (c) provides special rules for application of section 318 (a) (1) (relating to constructive ownership of stock between members of a family) in the case of a distribution in redemption under paragraph (3) of subsection (b) (relating to termination of a shareholder's interest). Under subparagraph (A) of paragraph (2), it is provided that section 318 (a) (1) shall not apply, i. e., stock owned by members of the family of the distributee would not be attributed to him immediately after the distribution in redemption, if the distributee himself has no interest in the corporation, including but not limited to an interest as officer, director or employee other than an interest as a creditor, and such distributee does not acquire such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of distribution in redemption.

Moreover, in order to qualify for nonattribution between members of a family, subparagraph (A) (iii) requires that the distributee, under regulations prescribed by the Secretary or his delegate, file an agreement to notify the Secretary or his delegate of any acquisition of any interest (other than by bequest or inheritance) within the 10-year period and to retain such records as the Secretary or his delegate may prescribe as necessary for the application of paragraph (2). Thus, your committee anticipates that the Secretary or his delegate may require that the distributee retain personal income tax returns and other records indicating fully the amount of tax which would have been payable had the redemption not been treated as a distribution in full payment for his stock.

In the event that the distributee acquires an interest in the corporation (other than by bequest or inheritance) within the 10 years from the date of distribution, then the period of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to tax) resulting from such acquisition, include 1 year following the date the distributee, in accordance with regulations, notifies the Secretary or his delegate. Such assessment and collection may be made, notwithstanding any provision of law or rule of law which would otherwise prevent such assessment and collection.

While your committee intends that interest resulting from the deficiency would be assessed and collected, your committee also intends that credit shall be allowed for any tax paid at capital gains rates at the time of the termination of the interest of the shareholder. Determination of the tax attributable to the inclusion of income for the year of redemption, shall, however, be made without regard to any other erroneous omissions from, or inclusions in, income of the year of original redemption.

Subparagraph (B) of paragraph (2) sets forth an overall qualification to application of subparagraph (A) of such paragraph. Under subparagraph (B), it is provided that subparagraph (A) shall not apply, if any portion of the stock redeemed was acquired directly or indirectly within the 10-year period ending on the date of the distribution by the distributee from a person, the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a). For example, if an individual owning all of the stock of a corporation gave half of such stock to his wife in 1955, and in 1960 effects a redemption of all of his wife's shares (the interest of the wife in the corporation otherwise being terminated), subparagraph (A) would not be applicable.

Subparagraph (B) also provides another rule for the nonapplication of subparagraph (A). If any person owns (at the time of distribution) stock, the ownership of which is attributable to the distributee under section 318 (a), and such person acquired any stock in the corporation directly or indirectly from the distributee within the 10-year period ending on the date of the distribution subparagraph (A) would not be applicable. Thus, if, in the preceding example, the husband's shares were redeemed and the husband otherwise terminated his interest in the corporation, subparagraph (A) would similarly not be applicable.

The limitations of subparagraph (B) applies whether the acquisition is by gift or is for consideration.

Subparagraph (B) qualifies the application of subparagraph (A) in any case in which the acquisition of the shares (described in subparagraph (B) (i)) or the disposition of shares (described in subparagraph (B) (ii)) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax. A transfer of stock by the transferor to a person whose stock would be attributable to the transferor, within the 10-year period described in subparagraph (B) shall not be deemed to have as one of its principal purposes the avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor.

Subsection (d) of section 302 corresponds to section 302 (b) of the House bill and section 115 (g) of the 1939 Code. Under this subsection, it is made clear that, except where otherwise provided, in subchapter C, if a corporation redeems its stock and if subsection (a) does not apply, i. e., if the redemption is not treated as a distribution in full or part payment in exchange for the stock, that such redemption shall be treated as a distribution of property to which section 301 applies.

Section 303. Distributions in redemption of stock to pay death taxes

This section corresponds to section 303 of the House bill and section 115 (g) (3) of the 1939 Code. Your committee has retained the provisions of the House bill which expand and liberalize the application of section 115 (g) (3).

Subsection (a) of section 303 sets forth the general rule of applicability of this section by providing the extent to which the distribution of property to a shareholder after June 18, 1954 by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent shall be treated as a distribution in full payment of the stock so redeemed.

As under existing law, paragraph (1) of subsection (a) provides that the amount of such distribution which will not, by virtue of this section, be treated as a dividend may equal the estate, inheritance, legacy and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death. This provision corresponds to section 115 (g) (3) of existing law.

Paragraph (2) conforms to the new provision added by the House bill and permits application of section 303 also to amounts distributed to the extent of the amount of the funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 (a) (1) in the case of an estate of a decedent nonresident not a citizen of the United States).

Subsection (b) sets forth specific limitations on the application of subsection (a). Under paragraph (1) of subsection (b), it is provided that subsection (a) shall apply only to amounts distributed after the decedent's death and within the time specified under subparagraphs (A) and (B).

Under subparagraph (A) of paragraph (1), it is set forth that the amount involved must be distributed within the period of limitations provided in section 6501 (a) for the assessment of Federal estate tax (determined without the application of any provision other than section 6501 (a)) or within 90 days after the expiration of such period. This subparagraph, in effect, requires the period within which the redemption must be made may not (subject to the provisions of subparagraph (B)), exceed 3 years and 90 days from the date set for filing of the estate tax return irrespective of any other period which would otherwise operate to extend the period of limitations.

Subparagraph (B) provides a special rule extending the period provided under subparagraph (A) 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. In such case, section 303 shall apply to amounts distributed at any time before the expiration of 60 days after the decision of the Tax Court becomes final. Subparagraph (B) has reference solely to bona fide contests in the Tax Court. This subparagraph is not intended to apply in the case of a petition of redetermination of a deficiency which is initiated solely for the purpose of extending the period within which section 303 would otherwise be applicable.

Paragraph (2) of subsection (b) represents an expansion of existing law by incorporating under subparagraph (A) the percentile limitation under section 115 (g) (3) enacted as a part of the Revenue Act of 1951 (35 percent of the gross estate) and in subparagraph (B) incorporating the original percentile limitation enacted as part of the Revenue Act of 1950 (50 percent of the net estate). Thus, stock of a corporation will qualify for treatment under section 303 either if the value of the stock for estate tax purposes comprises more than 35 percent of the value of the gross estate of such decedent, or if such value comprises more than 50 percent of the net estate of such decedent.

Paragraph (2) of subsection (b) makes another expansion of section 115 (g) (3) of the 1939 Code by permitting, in certain instances, stock of 2 or more corporations to qualify as 1 corporation for the purposes of computing the percentile requirements under subparagraphs (A) and (B). Thus, stock of two or more corporations shall be treated as a stock of a single corporation for purpose of subparagraphs (A) and (B), to the extent that (with respect to each of such corporations) more than 75 percent in value of the oustanding stock is includible in the gross estate. For example, if the estate of decedent X presents the following facts:

Gross estate	$1, 500, 000
Net estate	750, 000

Stock of corporations includible in gross estate	Value of stock includible in gross estate	Percentage of ownership of stock includible in gross estate
Corporation A	$300, 000	50
Corporation B	300, 000	100
Corporation C	200, 000	100

Corporations B and C, but not corporation A, would for the purposes of section 303 be treated as stock of a single corporation. In consequence, a redemption of the stock of corporation A would not qualify with respect to the percentile requirements of section 303 (b) (2) (A) or (B) since the value of stock of corporation A includible in the gross estate is less than 35 percent of the gross estate ($525,000) and also less than 50 percent of the net estate ($375,000). In the case of corporations B and C, a redemption of the stock of either would qualify under section 303 (b) (2) (A) since the value of both corporations treated as a single corporation includible in the gross estate ($550,000) exceeds 35 percent of the gross estate ($525,000) and also since such value exceeds 50 percent of the net estate ($375,000).

Your committee has added a new provision in subparagraph (B) of paragraph (2) that for the purpose of the 75 percent requirement in that subparagraph, stock which at the death of the decedent represents the interest of the surviving spouse in property held by the decedent and the surviving spouse as community property, shall be treated as having been included in the gross estate of the decedent.

Under subsection (c), your subcommittee has further expanded the application of existing law and section 303 of the House bill that if after the death of a decedent his estate receives stock whose basis is determined by reference to, or by allocation of, the basis of the stock which was included in the gross estate, then section 303 will apply to a redemption of the new stock, to the same extent section 303 would have applied to the redemption of the old stock, within the time limitations described in subsection (b) (1). This subsection represents an expansion of section 115 (g) (3) of the 1939 code, as well as section 303 of the House bill. This subsection applies notwithstanding the provisions of section 306.

Section 304. Redemption through use of related corporations

Section 304 corresponds to section 304 of the House bill and incorporates the substance of section 115 (g) (2) of existing law. As in the House bill, the principle of section 115 (g) (2) is expanded to include cases of so-called "brother-sister corporations." The effect of the operation of section 304 is to characterize as redemptions distributions which are cast in the form of sales. The distributions in redemption shall be examined for taxability subject to the rules of sections 302 (relating to distributions in redemption of stock) and 303 (relating to distributions in redemption of stock to pay death taxes).

Subsection (a) sets forth the new general rule added by this section by providing in paragraph (1) that in any case in which 1 or more persons who are in control of each of 2 corporations (brother-sister corporations) sell the stock of one of the corporations to another of such corporations the proceeds of such sale shall be considered to be an amount distributed in redemption of the stock of the corporation which purchased the stock. The stock thus acquired will be treated as a contribution to the capital of the acquiring corporation made by such shareholder, and accordingly will take as its basis the basis in the hands of the shareholder.

The general rule of present law, preserved in the parent-subsidiary area, is set forth in paragraph (2). Under this rule, supplemented by subsection (b) (2) (B), if a subsidiary corporation purchases outstanding stock of its parent the proceeds of such sale shall be considered to be first a distribution by the subsidiary to the parent and then immediately thereafter a distribution by the parent corporation in redemption of its own stock.

Subsection (b) contains special rules for the application of subsection (a). Paragraph (1) of subsection (b) states a rule for the purpose of applying section 302 (b) (relating to redemptions of stock treated as exchanges). In the case of any acquisition of stock to which section 302 (a) applies, determinations as to whether the acquisition is, by virtue of section 302 (b), to be treated as a distribution in part or full payment in exchange for such stock because such redemption is: (1) not equivalent to a dividend, (2) substantially disproportionate, (3) in complete termination of an interest, or (4) is made with respect to stock of certain railroad corporations shall be made by reference to the stock of the corporation issuing the stock purchased. In applying section 318 (a) (relating to constructive ownership of stock) with respect to section 302 (b) for purposes of this paragraph, section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

Paragraph (2) of subsection (b) contains a rule for determining the amount constituting a dividend. Subparagraph (A) states that in the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) applies (relating to brother-sister corporations) the determination of whether a sale of stock, treated as a redemption, is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

Subsection (c) provides that control, for purposes of this section means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. It is possible under this definition for 4 unrelated shareholders to be in control of a corporation, i. e., 2 shareholders may own 50 percent of the total combined voting power and 2 shareholders own 50 percent of the total value of the shares.

If a person is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of stock of another corporation, such person will be deemed to be in control of such other corporation. For example, if individual X owns 50 percent of the total combined voting power of corporation A, which in turn owns 50 percent of total combined voting power of corporation B, X will be deemed to be in control of corporation B.

Paragraph (2) of subsection (c) provides that the rules of section 318 (a) (relating to constructive ownership of stock) shall be applicable for purposes of determining control under paragraph (1) of subsection (c). For purposes of the preceding sentence section 318 (a) (2) (C) shall be applied without regard to the 50 percent limitation contained therein.

Section 305. Distributions of stock and stock rights

Section 305 of the bill corresponds in part to section 305 of the House bill and provides the basic rule for tax treatment to a shareholder receiving a distribution of stock or stock rights from a corporation as a dividend. The scope of this section is considerably narrowed from the House version of section 305 and is limited to the effect at the shareholder level of distributions of dividends in stock and stock rights of the corporation in which the taxpayer is a shareholder. Unlike the House bill, the section does not relate to stock distributions received in connection with exchanges in a reorganization to which section 354 applies (dealing with exchanges of stock in certain reorganizations) nor with distributions of stock of a controlled corporation to which section 355 applies.

The general rule of section 305, set forth in subsection (a), provides that except where the distribution is "in lieu of money," no amount shall be includible in income upon the receipt by a shareholder from a corporation, of shares of its stock, or its stock rights, which are issued with respect to the stock held by such shareholder. Although section 305 in its function generally corresponds to section 115 (f) of the 1939 code, the rule of section 115 (f) (1) of existing law is changed under section 305 to eliminate (with exceptions provided in subsection (c)) shareholder taxation upon the receipt of stock or stock rights. In this respect, the problems involved in the line of court decisions such as *Koshland* v. *Helvering* (298 U. S. 441); *Helvering* v. *Gowran* (302 U. S. 238); *Wiegand* v. *Commissioner* (194 F. 2d 479), etc., wherein the taxability of a stock distribution is dependent upon whether the proportionate interest of the shareholder in the corporation has been altered, are eliminated.

Subsection (b) of section 305 which corresponds in part to section 115 (f) (2) of existing law provides an exception to the rule of subsection (a), for distributions in lieu of money. Under paragraph (1) of subsection (b) a distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies if the distribution is made in discharge of preference dividends on stock of the corporation for the taxable year of the distribution or for the preceding taxable year. Under paragraph (2) of subsection (b), if the distribution of stock or stock rights is, at the election of any of the shareholders, payable either in such stock (or stock rights) or property, the distribution, without regard to whether the election is exercised before or after the dividend declaration, will likewise be treated as a distribution of property to which section 301 applies. The amount of such distribution will be measured by reference to the property subject to the election.

Section 306. Dispositions of certain stock

Section 306 of your committee's bill represents a substantially different approach to the problem of the so-called preferred stock bail-out from that found in the House bill. The House bill deferred its sanction on the use of preferred stock as a means of removing earnings from a corporation at the rates applicable to capital gains until the time of its redemption, regardless of whether the shareholder redeeming the stock was the original recipient. Under your committee's approach, on the other hand, the original recipient of the dividend stock is, in general, taxed on its disposition as if there had been a cash, rather than a stock, distribution to him in the first instance.

Your committee introduces a new term into the tax law, "section 306 stock." In general, section 306 stock is preferred stock issued as a stock dividend, whether in connection with a corporate reorganization or otherwise, at a time when the issuing corporation has earnings and profits.

Subsection (a) of section 306 prescribes the general rules as to the tax treatment of the disposition or redemption of section 306 stock. Paragraph (1) relates to dispositions of such stock other than by redemption. The term disposition includes sales and also includes pledges of the stock under certain circumstances, particularly where the pledgee can look only to the stock itself as his security. If the section 306 stock is sold the amount realized is treated as gain from the sale of property which is not a capital asset to the extent of the stock's ratable share of earnings and profits of the issuing corporation at the time of its distribution. Thus, assume that a shareholder owns 1,000 shares of the common stock of a corporation and that they are the only shares of its stock outstanding. Assume also that the shareholder acquires 1,000 shares of preferred stock with a fair market value for each share of $100 issued to him as a dividend on his common stock at a time when the corporation has $100,000 in accumulated earnings. There is no tax to the shareholder at the time of receipt of the stock but it is characterized as section 306 stock. If it is sold for $100,000 the shareholder will be taxed on the entire sale proceeds at the rates applicable to ordinary income.

The determination of the section 306 stock's ratable share of earnings at the time of its distribution is to be made in accordance with its fair market value at such time. It should also be noted that it would be immaterial that $100,000 were distributed to the stockholder as a dividend on his common stock subsequent to the distribution of the stock dividend. The stock dividend is nevertheless section 306 stock because of the corporate earnings in existence at the time of its distribution. A shareholder may, in such a case, only dispose of his section 306 stock through redemption by the issuing corporation and thereby avoid its inherent ordinary income characteristics. See discussion of paragraph (2) of subsection (a), below.

Subparagraph (B) of paragraph (1) provides that if the amount received from the sale of section 306 stock exceeds the amount treated as ordinary income, such excess, shall, to the extent of gain, be accorded capital-gain treatment. Thus, if in the preceding example the stock had been sold for $110,000 (instead of $100,000) the $10,000 would be taxed at the rates applicable to capital gain. Subparagraph (C) of paragraph (1) provides that in no event is any loss to be allowed with respect to the sale of section 306 stock.

Paragraph (2) of subsection (a) provides that if the section 306 stock is redeemed, the amount realized is to be treated as a distribution of property to which section 301 applies. Thus, if the section 306 stock was distributed at a time when there was an amount of corporate earnings attributable to it equal to its full fair market value at that time, but if there are no corporate earnings, accumulated or current, at the time of redemption, the amount received on redemption of section 306 stock would be treated under section 301 as a return of capital. No loss would be allowed in such a case under section 301.

It should be noted that where section 306 stock is redeemed the rules of section 302 (a) and (b), relating to cases where amounts received in redemption of stock will be taxed at capital gain rates, are not applicable. Section 306 operates independently of section 302 and contains its own rules concerning instances where your committee does not consider it appropriate to tax proceeds received with respect to section 306 stock at the rates applicable to ordinary income.

Subsection (b) of section 306 sets forth the cases excepted from your committee's general treatment of section 306 stock. Paragraph (1) (A) provides that if a shareholder sells his entire stock interest in the corporation (to a person other than one through whom the ownership of the stock would, under section 318, be attributed back to him) the sale shall be treated as a sale or exchange of property; that is, a capital asset, or noncapital asset, depending on the manner in which it is held (as inventory or otherwise) by the seller.

Subparagraph (B) provides that if the complete termination is effected by means of the redemption route, rather than sale, then the redemption is treated as one to which section 302 (b) (3) applies. Thus, the rules of constructive ownership of stock among members of a family are waived to the same extent provided in section 302 (c) (2). Accordingly, if a shareholder redeems all his section 306 stock, together with the stock with respect to which it was distributed, the tax consequences of such a redemption (or subsequent reacquisition of an interest) are to be governed by section 302 (b) (3), as supplemented by section 302 (c) (2).

Paragraph (2) of subsection (b) excepts from the general rules of this section, redemptions of section 306 stock pursuant to a partial or complete liquidation, within the meaning of part II of this subchapter. In the case of a partial liquidation your committee contemplates a contraction of the corporate business so that it is immaterial that the distribution in partial liquidation is with respect to section 306 stock. A bona fide contraction of the corporate business is not considered a means of distributing corporate earnings to shareholders at capital gains rates.

Paragraph (3) of subsection (b) excepts from the general rules of this section, transactions with respect to which gain or loss is not recognized. In addition to the receipt of stock in exchange for section 306 stock pursuant to a reorganization, your committee intends to include exchanges to which section 1036 (corresponding to section 112 (b) (2) of the 1939 Code) applies. However, in the case of a reorganization, unless the stock received in exchange for the section 306 stock is common stock, it will also be characterized as section 306 stock by reason of section 306 (c) (1) (C). This last provision will also characterize as section 306 stock, stock received in an exchange to which section 1036 relating to certain exchanges of stock for stock applies where the exchanged stock was section 306 stock.

Paragraph (4) of subsection (b) excepts from the general rule of subsection (a) those transactions not in avoidance of this section where it is established to the satisfaction of the Secretary that the transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Subparagraph (A) of this paragraph applies to cases where the distribution itself, coupled with the disposition or redemption was not in pursuance of such a plan. This subparagraph is intended to apply to the case of dividends and isolated dispositions of section 306 stock by minority shareholders who do not in the aggregate have control of the distributing corporation. In such a case it would seem to your committee to be inappropriate to impute to such shareholders an intention to remove corporate earnings at the tax rates applicable only to capital gains.

Subparagraph (B) of subsection (b) (4) applies to a case where the shareholder has made a prior or simultaneous disposition (or redemption) of the underlying stock with respect to which the section 306 stock was issued. Thus if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a tax avoidance disposition since he has previously parted with the stock which allows him to participate in the ownership of the business. However, variations of the above example may give rise to tax avoidance possibilities which are not within the exception of subparagraph (B). Thus if a corporation has only one class of common stock outstanding and it issues stock under circumstances that characterize it as section 306 stock, a subsequent issue of a different class of common having greater voting rights than the original common will not permit a simultaneous disposition of the section 306 stock together with the original common to escape the rules of subsection (a) of section 306.

Section 306 (c) sets forth the definition of section 306 stock. Paragraph (1) (A) of subsection (c) provides that section 306 stock is any stock (other than common stock issued with respect to common stock) distributed to the seller thereof, if by reason of section 305 (a) any part of such distribution was not includible in the gross income of the shareholder. Thus, a stock dividend (other than a dividend in common stock issued with respect to common stock) is considered section 306 stock. A common stock dividend issue, with respect to arrearages on preferred stock would be section 306 stock if otherwise not taxable as being in lieu of currently owing dividends on such stock.

Subparagraph (B) of paragraph (1) of subsection (c) provides that stock received in connection with a plan of reorganization within the meaning of section 368(a), or in a disposition or exchange to which section 355 applies, is section 306 stock, if the effect of the transaction was substantially the same as the receipt of a stock dividend. The subparagraph also makes it clear that section 306 stock exchanged for section 306 stock shall retain its characteristics. This subparagraph provides that common stock received as a result of a corporate reorganization or separation shall not be considered section 306 stock in any event. Thus, the shareholder is always permitted an opportunity to downgrade preferred stock characterized as section 306 stock in his hands by causing a recapitalization and exchange of such stock for common stock.

Subparagraph (C) provides that section 306 stock includes stock the basis of which in the hands of the shareholder selling or otherwise disposing of such stock is determined by reference to the basis of section 306 stock. Subparagraph (C) however, is limited to cases other than those to which subparagraph (B) is applicable, that is, the reorganization type of case which would otherwise be within this subparagraph. Under this subparagraph common stock could be section 306 stock. Thus, if a person owning section 306 stock transfers it to a corporation controlled by him in exchange for common stock, the common stock received would be section 306 stock in his hands and subject to the rules of subsection (a) on its disposition. Subparagraph (C) also would remove from the category of section 306 stock, stock owned by a decedent at death since such stock takes a new basis under section 1014.

Paragraph (2) of subsection (c) excepts from the definition of section 306 stock any stock no part of the distribution of which would have been a dividend at the time of distribution if money had been distributed in lieu of the stock. Thus, preferred stock received at the time of original incorporation would not be section 306 stock. Also, stock issued at the time an existing corporation had no earnings and profits would not be section 306 stock.

Subsection (d) provides that stock rights shall be treated as stock for purposes of this section and if stock is acquired through the exercise of stock rights, such stock shall be treated as section 306 stock to the extent the rights themselves had the character of section 306 stock at the time of distribution.

Subsection (e) provides that for purposes of determining whether stock is within the definition of section 306 stock and is later exchanged for common stock in the same corporation, whether or not such exchange is pursuant to a conversion privilege contained in the section 306 stock, shall be considered as removed from the section 306 category. This rule would apply in cases to which subsection (c) (1) (B) does not apply, that is, any exchanges which may not be considered recapitalizations. Paragraph (2) of subsection (e) provides that common stock with respect to which there is a privilege of converting into stock other than common stock or property, shall not be treated as common stock. This rule is an exception to the rule described in paragraph (1) of this subsection. In such case it is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

Subsection (f) of section 306 is intended to make clear that where section 306 stock is disposed of by a nonresident alien or foreign corporation it will be treated as if the amount of the proceeds had been received from the corporation as a dividend at the time of the distribution of the section 306 stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodical gains, profits, and income within the meaning of section 87 (a) or section 881 (a), relating, respectively, to the tax on nonresident alien individuals and on foreign corporations not engaged in business in the United States.

Subsection (g) of section 306 is intended to prevent the avoidance of this section by changes in the terms of the stock. Thus, this section is intended to prevent the issuance of low value stock, in order to limit the amount of corporate earnings to be assigned to it at the time, and a subsequent change in its terms to render it more valuable. In such a case the value of the stock and its ratable share of earnings shall be redetermined at the time of the change in terms and conditions of the stock. If the value is greater or the ratable share of earnings is higher at that time, then the inherent ordinary income characteristics of the stock shall be revised to reflect conditions at the time of the change.

Subsection (g) (3) clarifies the application of subsection (c) (2) to the kind of case described. Subsection (c) (2) does not characterize stock as section 306 stock in any event when there are no earnings and profits at the time of its distribution. Accordingly, subsection (c) (2) does not apply unless the stock meets the requirements of such subsection both at the time of such distribution and at the time of such change.

Subsection (h) removes from the application of this section stock which is received in a distribution or reorganization to which the Internal Revenue Code of 1939 applies, even though such stock would be considered section 306 stock if this code applied to the distribution or reorganization. For example, section 393 (b) (2) allows an election to have the Internal Revenue Code of 1939 apply to certain reorganizations with respect to which a ruling was requested of the Secretary before June 18, 1954. If this election is made, stock which would otherwise be section 306 stock will not be characterized as such even though distributed some time in 1955. Subsection (h) also provides that the tax treatment of the disposition or redemption of this stock shall be determined as if the Internal Revenue Code of 1939 (as modified by the 1954 Code without regard to section 306) continued to apply in respect of such disposition or redemption.

The removal, in effect, of existing stock issues from the application of section 306 is not intended as a commentary upon existing law in the preferred stock bail-out area.

Section 307. Basis of stock and stock rights acquired in distributions

This section corresponds to section 307 of the House bill and section 113 (a) (19) of the 1939 Code. However, your committee has limited the application of section 307 to distributions of stock and stock rights, to which section 305 (a) applies. Unless subsection (b) applies and the distributee elects within its rules, the basis of the stock (called "old stock") in respect of which the distribution of stock and stock rights (called "new stock") is made shall be allocated under regulations prescribed by the Secretary or his delegate, between the "old stock" and the "new stock."

Subsection (b) describes a special rule for the treatment of certain stock rights, which is the same as the rule described in section 307 (b) of the House bill.

Paragraph (1) of subsection (b) sets forth the general rule that if rights to acquire stock are received, and the fair market value of such rights is less than 15 percent of the fair market value of the stock with respect to which such rights were distributed, then the basis of such rights shall be zero, unless the taxpayer elects, as provided in paragraph (2) of subsection (b), to determine such basis under the method of allocation provided in subsection (a). Paragraph (2) of subsection (b) sets forth rules respecting the election to allocate basis under subsection (a). Such paragraph provides that the election shall be made in the return for the taxable year in which the rights were received. Such election shall be irrevocable when made and shall be made in such manner as the Secretary or his delegate may by regulations prescribe.

SUBPART B—EFFECTS ON CORPORATIONS

Section 311. Taxability of corporation on distributions

Section 311 corresponds to section 308 of the House bill and provides rules for the tax treatment to a corporation upon the distribution by it of property to its shareholders.

While no statutory counterpart for section 311 appears in the 1939 Code certain court decisions have been considered to hold that a corporation realizes no gain or loss upon a distribution of property to its shareholders. Section 311 incorporates this general rule but, through three exceptions appropriate safeguards are provided to prevent tax avoidance.

Subsection (a) of section 311 accordingly provides that no gain or loss shall be recognized to a corporation on the distribution with respect to its stock of stock or stock rights, or property. Thus, the fact that the property distributed has appreciated or depreciated in value over its adjusted basis to the distributing corporation will in no way alter the application of subsection (a). Your committee does not intend, however, through subsection (a), to alter existing law in the case of distributions of property, which has appreciated or depreciated in value, where such distributions are made to persons other than shareholders or are made to shareholders in a capacity other than that of a shareholder. For example, distribution of property made to a shareholder in his capacity as a creditor of the distributing corporation is not within the rule of subsection (a). Likewise your committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of *Commissioner* v. *First State Bank of Stratford* (168 F. 2d 1004, cert. den. 335 U. S.).

Subsection (b) of section 311 excepts from the general rule certain distributions of LIFO inventory. Paragraph (1) provides that if a corporation inventorying goods under the method provided in section 472 (relating to last-in, first-out inventories) distributes "inventory assets", then the amount of gain determined under subparagraphs (A) and (B) shall be treated as gain to the corporation recognized from the sale of such inventory assets.

Subparagraphs (A) and (B) of paragraph (1) provide that the amount of the gain shall be the amount by which (A) the "inventory amount" of such assets determined under a method of inventorying goods other than the LIFO method (authorized by section 471) exceeds the "inventory amount" of such assets determined under the LIFO method (provided in section 472).

Paragraph (2) (A) defines the term "inventory assets" to mean stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

Paragraph (2) (B) defines the term "inventory amount" to mean, in the case of inventory assets distributed during a taxable year, the amount of such inventory assets determined as if the taxable year closed at the time of such distribution.

Paragraph (3) of subsection (b) provides that the inventory amount of assets under a method authorized by section 471, i. e., a method other than the LIFO method, shall be determined under the retail method of valuing inventories if the corporation uses the retail method for the year of the distribution, or under the method of the lower of cost or market if the corporation does not so use the retail method.

Subsection (c) of section 311 corresponds in part to section 308 (c) of the House bill. It is here provided that in any case in which property is distributed to a shareholder with respect to his stock and such property is either subject to liability or the shareholder assumes a liability of the corporation in connection with the distribution and the amount of such liability exceeds the adjusted basis (in the hands of the distributing corporation) of such property, then gain shall be recognized as provided in this subsection. The amount of gain so recognized to the distributing corporation shall be an amount equal to the excess of the liability over such adjusted basis as if the property had been sold at the time of the distribution by the corporation. Thus, if property which is a capital asset having an adjusted basis to the distributing corporation of $100 and a fair market value of $1,000 (but subject to a liability of $900) is distributed to a shareholder, such distribution is taxable (as long or short term gain as the case may be) to the corporation to the extent of the excess of the liability ($900) over the adjusted basis ($100) or ($800). If the property subject to a liability were not a capital asset in the hands of the distributing corporation the gain would be taxable at rates applicable to the sale of noncapital assets. This latter distinction between the type of gain realized represents a change from the provisions of section 308 (c) of the House bill.

Section 312. Effect on earnings and profits

This section of your committee's bill corresponds to section 310 of the House bill and contains the rules applicable generally to subchapter C for determining adjustments to corporate earnings as a result of distributions pursuant to the various types of transactions described in such subchapter.

Subsection (a) provides the general rule for adjustments to earnings where property is distributed. If the distribution is in cash the earnings are decreased by the amount of such cash, and if it is in an obligation of the distributing corporation, the earnings are decreased by the principal amount thereof. If the distribution is in property the amount of the decrease is by the adjusted basis of such property. This rule is applicable whether the property has appreciated or depreciated in value. Thus, if property with a value of $100 is distributed but if there are only $75 of earnings and profits from which the distribution can be made, the taxable amount will be only $75. If the property cost the corporation only $50, however, its earnings and profits will be reduced only by $50, and $25 will remain in its earnings and profits account.

The House report indicated that this rule clarified existing law. Subsequent to the date of the House report two court decisions have taken a position to the contrary. *Commissioner* v. *Fannie Hirshon Trust* (C. A. 2d, May 17, 1954) and *Commissioner* v. *Estate of Ida S. Godley* (C. A. 3d, May 28, 1954). In view of these decisions your committee does not intend any implication from the enactment of section 312 (a) with respect to the effects of a distribution of property on earnings and profits and on the shareholders under the 1939 Code.

Subsection (b) of section 312 provides for an upward adjustment of earnings and profits where appreciated inventory assets are distributed, notwithstanding the status of existing law with respect to such distributions or distributions of other types of assets. Paragraph (1) provides that if inventory assets, as defined in paragraph (2), are distributed and if its fair market value exceeds its basis, then the corporate earnings shall be increased by the amount of such excess, and shall be decreased by the lesser of its fair market value or the earnings and profits (so increased). Your committee clarified this provision as it appeared in the House bill to insure that the required adjustments would not create a deficit in earnings and profits.

Paragraph (2) of subsection (b) defines inventory assets to mean (A) those items normally included in inventory and property held primarily for sale to customers, and (B) unrealized receivables or fees from sales or exchanges of assets other than inventory assets. Unrealized receivables or fees means rights to payment for assets other than capital assets or rights to payment for services. The House bill included in the definition of inventory assets, for the purpose of this subsection, certain depreciable business property. The inclusion of these assets was part of the solution to the collapsible corporation problem proposed in the House bill. Since your committee's bill contains a different solution to this problem, it appears appropriate to remove such assets from the definition of inventory assets.

Subsection (c) provides for proper adjustment to the earnings and profits where property distributed is subject to a liability, where the distributee assumes a liability in connection with the distribution, and for cases where gain is recognized to the distributing corporation under section 311 (b) or (c), relating to distribution of LIFO inventory and property subject to indebtedness in excess of its basis. In lieu of providing detailed statutory rules for these cases, your committee considers it appropriate that the rules be supplied by regulations.

Subsection (d) (1) corresponds to section 115 (h) of existing law and provides in general that the distribution of stock or securities by a corporation shall not be considered a distribution of earnings and profits. Subparagraph (A) provides that this rule shall apply if no gain to the distributee was recognized. Thus a distribution of stock in lieu of currently owing dividends on preferred stock would be considered a distribution of earnings, since gain is recognized to the distributee in such a case under section 305 (b). Subparagraph (B) provides that the general rule of this paragraph shall also apply to cases under section 305 (a), for example, a dividend in common stock on common.

Paragraph (2) of subsection (d) retains in the new Code the effect of section 115 (h) for years prior to the effective date of the new Code since corporate earnings are a continuing concept and transactions of earlier years must be taken into account to determine the amount of earnings on hand at some future time.

Paragraph (3) makes it clear that stock or securities includes rights to acquire stock or securities for purpose of the rules of subsection (d).

Subsection (e) corresponds to the third sentence of section 115 (c) of the existing Code. It makes clear that in the case of a partial liquidation (regardless of when carried out), or a redemption to which section 302 (a) applies, corporate earnings shall not be decreased by the part of the distribution properly chargeable to capital account. It is intended that the adjustments required an account of redemptions to which sections 302 (a) and 303 apply, shall also be made if those sections apply to the transaction by reason of section 304 (relating to redemption through the use of related corporations).

Subsection (f) repeats section 115 (l) of the 1939 Code and section 310 (e) of the House bill which relate to the effect on earnings and profits of gain or loss and of receipt of tax-free distributions. No change is intended in the rules of existing law. Subsection (f) (2) (B) has been amended, however, to conform to the new rule in section 307 (b) with respect to the elective allocation of stock basis to stock rights distributed on such stock. Where the term, "taxable dividend," is used in subsection (f) (2) it is intended that for years to which this Code is applicable is shall mean "treated as a dividend" in order that section 116, relating to partial exclusion of dividends received by individuals, will not vary the results under this subsection.

Subsection (g) repeats section 115 (m) of the 1939 Code and section 310 (g) of the House bill. This section relates to the effect on earnings and profits of increase in value of property accrued prior to March 1, 1913. No change from existing law is intended.

Subsection (h) repeats section 394 (d) and section 310 (g) of the House bill. This section relates to earnings and profits of certain personal service corporations. No change in existing law is intended.

Subsection (i) of section 312 replaces section 310 (c) of the House bill. The House bill provides detailed rules for allocating earnings and profits where there is a corporate separation. Your committee provides that the allocation in such cases shall be made under regulations. Thus, in a distribution or exchange to which section 355 applies (or so much of sec. 356 as relates to sec. 355), it is intended that the Secretary (or his delegate) shall have the power to provide for proper allocation of the earnings and profits of the distributing corporation to the controlled corporation (or corporations). As a result of such allocation, in no case may the earnings and profits of a corporation exceed its total net worth.

In a distribution or exchange to which section 355 applies and which is pursuant to a reorganization as defined under section 368 (a) (1) (D) (and takes place immediately after the corporate transfer of assets) the principle of the Sansome case (*Commissioner* v. *Sansome*, 60 F. 2d, 931 C. A. 2d (1932) cert. den., 287 U. S. 667) will be applied to allocate a portion of the earnings and profits of the distributing corporation to the controlled corporation. However, no deficit of a distributing corporation will ever be allocated to a controlled corporation.

In a distribution or exchange to which section 355 applies, but which is not pursuant to a reorganization within the terms of section 368 (a) (1) (D) the earnings and profits of the distributing corporation shall be decreased by the same amount as they would have been if the distributing corporation had transferred the stock of the controlled corporation to a new corporation in a reorganization to which section 368 (a) (1) (D) applied and immediately thereafter distributed the stock of such new corporation. In no case shall the earnings and profits of the controlled corporation after the distribution be less than the amount by which the earnings and profits of the distributing corporation are decreased. Whenever the earnings and profits of the controlled corporation, the stock of which is distributed or exchanged, are less than this amount (as well as when such corporation has a deficit) the earnings and profits of the controlled corporation shall be so increased as to equal this amount. On the other hand, if the earnings and profits of the controlled corporation are more than this amount, they shall not be either decreased or increased. In no case shall any part of a deficit of the distributing corporation be allocated to a controlled corporation.

Subsection (j) which has no counterpart in the House bill relates to the adjustment of earnings and profits on account of the distribution of proceeds of a loan insured by the United States. It provides that when property is distributed, the earnings and profits shall be increased by the excess of United States Government insured loans outstanding over the adjusted basis of the property, determined without regard to any adjustment under section 1016 (a) (2) relating to the depreciation, etc., upon distributions of property by the corporation. It is intended that the property distributed not be restricted to the loan proceeds, but includes any distribution, whether or not equal in amount to the excess of the loan over the adjusted basis.

To the extent that any distribution exceeds the excess of the loan over the adjusted basis, earnings and profits not arising out of the increase herein provided may be decreased, and if no other earnings and profits are available, the capital may be decreased. It is intended that as long as such loan is outstanding, the value of any distribution shall be treated as a dividend to the shareholder to the extent that it does not exceed the excess of the loan over the adjusted basis. In no case may an accumulated deficit in earnings and profits of the corporation be used to reduce the increase in earnings and profits to be made under this section.

It is intended that the subsection shall apply with respect to a loan made, guaranteed, or insured by any agency or instrumentality of the United States, including the Federal Housing Administration. For this purpose, a commitment to guarantee or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan. The subsection applies to distributions made on or after June 18, 1954, without regard to when the loans may have been guaranteed, or insured by the United States.

Your committee intends that no implication be drawn from the enactment of this subsection with respect to any decision made or litigation pending under present law with respect to this subject matter, whether or not such loans are made, guaranteed, or insured by the United States, or with respect to any other provision of this bill which may be relevant to the same subject matter, such as section 341, relating to collapsible corporations.

SUBPART C—DEFINITIONS; CONSTRUCTIVE OWNERSHIP OF STOCK

Section 316. Dividend defined

Section 316 sets forth the definition of a dividend for purposes of the subtitle. This definition corresponds generally to section 115 (a) and section 115 (b) of the Internal Revenue Code of 1939 and to section 312 (a) of the House bill. However, your committee has not adopted a rule which appeared in section 312 (a) of the House bill, incorporating the principle of *Dixie Pine Products Co. v. Commissioner* (320 U. S. 516). This rule relates to the effect on earnings and profits where the liability for Federal income taxes is the subject of a bona fide contest by a taxpayer using the accrual method of accounting.

Subsection (a) sets forth the general rule that the term "dividend" means any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913 or out of earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) without regard to the amount of the earnings and profits at the time the distribution was made.

The rule of section 115 (b) is adopted providing that every distribution, except as otherwise provided, is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Paragraph (1) of subsection (b) incorporates the provision of section 115 (a) of existing law providing an exception to the definition of a dividend in subsection (a) for certain dividends paid to policyholders by insurance companies.

Paragraph (2) of subsection (b) restates existing law under section 115 (a) of the Internal Revenue Code, relating to distributions by personal holding companies, with conforming changes.

Section 317. Other definitions

Section 317 sets forth the definitions of "property" and "redemption of stock" for purposes of this part. The definitions of "participating stock," "nonparticipating stock," and "securities" in the House bill do not appear in your committee's bill.

Subsection (a) of this section defines "property" to mean money, securities, and any other property, except that the term does not include stock in the corporation making the distribution (or rights to acquire such stock).

Subsection (b) defines "redemption of stock." For the purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is canceled, retired, or held as treasury stock. In general your committee intends by this subsection to make clear that the acquisition by a corporation of its stock thereafter held in the treasury of such corporation constitutes a "redemption" of such stock. The House bill provided that a distribution of property accompanying a reduction in the par or stated value of the stock shall be treated (to the extent of the amount of such reduction) as a distribution in redemption of stock. No inference is to be drawn by the elimination of this provision in your committee's bill as to the status of existing law in this area.

Section 318. Constructive ownership of stock

This section describes the area in which although in fact transactions related to stockownership are in connection with a specific individual, ownership of stock is deemed to be in the hands of persons other than the person directly involved. Thus, for the purpose of determining whether a redemption of stock qualifies as a disproportionate redemption of stock within the meaning of section 302

(b) (2), consideration is given not only to the stock held by such person but also to stock owned by members of his family. For example, if an individual, A, owns 50 of the 100 outstanding shares of the stock of a corporation and 11 shares are redeemed by the corporation from him the amount received would be treated as if received in connection with a disproportionate redemption and accordingly would be treated as if received in payment for such stock. However, if the wife of A owns the other 50 shares of the corporation, these rules provide that A shall be deemed to own all of the outstanding shares and accordingly the redemption of 11 shares would not qualify as a disproportionate redemption.

The area of constructive ownership includes members of the family, persons having interests in partnerships, estates, trusts, and corporations, such partnerships, estates, trusts, and corporations and stock held under an option.

In the family area (sec. 318 (a) (1)) an individual is deemed to own stock owned by his parents, his children, and his grandchildren. Thus, if an individual, H, owns 20 of the 100 outstanding shares of stock of a corporation, his wife, W, owns 20 shares of such stock, his son, S, owns 20 of such shares and his grandson, G, owns 20 of such shares, H will be deemed to own 80 of such shares. W likewise will be deemed to own 80 of such shares as will also S. However, the grandson will be deemed only to own 40 of such shares, that is, his own and his father's.

With respect to partnerships, estates, trusts, and corporations, (sec. 318 (a) (2) (A) and (B)) if a redemption is made of the stock of a partner, the application of the disproportionate redemption rule will be made including in the stock ownership of the partner his proportionate interest in stock owned by his partnership. Likewise, if stock is redeemed from a partnership, such partnership will be deemed to own all of the stock owned by the partners. In the case of trusts, a similar rule applies, i. e., the beneficiary or grantor is deemed to own his proportionate interest in the stock owned by the trust or estate and the trust or estate is deemed to own all of the stock owned by its beneficiaries or grantors. This rule applies to all estates and all trusts including those relating to grantors and others treated as substantial owners but does not apply to employees' trusts described in section 401 (c) which are exempt from tax under section 501 (a).

The attribution of ownership with respect to corporations is restricted (sec. 318 (a) (2) (C)) to persons who own more than 50 percent in value of the stock of a corporation. In such case the individual is deemed to own his proportionate interest in the stock owned by such corporation and the corporation is deemed to own all of the stock owned by him.

In any of the cases above described where stock, though not owned, is subject to an option, the holder of such option is deemed to own such stock (sec. 318 (a) (3)).

All of these rules may be applicable in a given case and for this purpose constructive ownership is deemed to be actual ownership with certain limitations. Thus, in the case in which an individual, H, owns 20 of the 100 outstanding shares of stock of a corporation, his wife, W, owns 20 of such shares, his son, S, owns 20 of such shares, and his grandson, G, owns a similar number of shares, the rules provide that H, W, and S own 80 shares. However, if the remaining 20 shares of stock are owned by a corporation wholly owned by H, then H, W, and S will all be deemed to own the stock in fact owned by the corporation. A similar result will follow if H is the sole beneficiary of a trust or estate which owns such shares. This rule is provided by section 318 (a) (4) (A).

Section 318 (a) (4) (B) provides an exception with respect to the treatment of constructive ownership as actual ownership. Thus, it is provided that stock constructively owned by reason of ownership by another member of the family cannot be treated as owned by the person to whom they are constructively charged for the purpose of attributing such ownership to a relative to whom under the rules provided in section 318 (a) (1) such ownership is not directly attributable. For example, in the case described above in which the grandson, G, owns 20 of the outstanding 100 shares, his father, S, owns in fact 20 of such shares but is deemed to own in addition the stock owned by his parents H and W and his son. However, G is not deemed to own the stock of H and W. A further example would be the case in which the stock ownership of H, W, and S is the same as that described above but in lieu of the grandson owning 20 shares the wife of S owns 20 shares. In such case, H and W would be deemed to own 60 shares and S would be deemed to own 80 shares because the stock owned by his wife would be attributable to him, which stock would not however be attributable to his parents, H and W.

Section 318 (a) (4) (C) provides a rule prescribing that when stock is owned by an individual but is subject to an option the rules applicable to options shall apply in determining constructive stock ownership. This rule has the effect of allowing constructive ownership to be treated as actual ownership in order to avoid the effect of section 318 (a) (4) (B).

Part II—Corporate Liquidations

GENERAL

Part II of subchapter C relating to corporate liquidations corresponds to part II of the House bill. However, your committee has made a substantial change in the approach adopted by the House with respect to corporate liquidations generally. Under the House provisions, part II limited the amount subject to tax at the time of complete or partial liquidation of a corporation to the excess of the basis of assets in the hands of the liquidating corporation over the basis of the stock in the shareholder's hands. This approach does not appear in part II of your committee's bill. In lieu of this your committee has in large measure returned to the basic provisions relating to liquidations under the 1939 code. Thus, there appears in part II of your committee's bill the substance of section 115 (c), section 112 (b) (6), section 112 (b) (7) and section 117 (m) of such code.

On the other hand, those provisions of the House bill which were designed to meet the problems raised in *Commissioner* v. *Court Holding Company* (324 U. S. 331) relating to taxation of gain on sales made in the course of liquidation of a corporation and in *Kimbell-Diamond Milling Co.* (14 T. C. 74, aff'd 187 Fed. 2d 718 (C. A. 5, 1951)) relating to the basis of assets received upon the liquidation of a subsidiary by its parent are retained in substance in part II of your committee's bill.

In addition, certain changes have been made in those provisions of the 1939 code incorporated in part II.

SUBPART A—EFFECTS ON RECIPIENTS

Section 331. Gain or loss to shareholders in corporate liquidations

Section 331 restates in effect the provisions of section 115 (c) of the 1939 Code by providing in paragraph (1) that amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock of the shareholder. Paragraph (2) provides that amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock of a shareholder.

The term "partial liquidation" is defined in section 346. Such term as here defined differs considerably from that provided in the House bill at section 336. The term "complete liquidation", unlike the House version, is not defined in your committee's bill.

Subsection (b) of section 331 relating to distributions in liquidation of a corporation is intended to make clear that section 301 shall not apply to any distribution of property in partial or complete liquidation of a corporation. This subsection has been inserted by your committee to clarify the treatment of certain redemptions of stock which, while entitled to capital-gains treatment under section 302 (a), are nevertheless not made in connection with a partial or complete liquidation of the corporation. Such portion of section 115 (c) of the 1939 Code which provides for capital-gains treatment where the redemption does not terminate a part of the business of the corporation is, under your committee's bill, treated under section 302, or section 301, as the case may be.

Section 332. Complete liquidations of subsidiaries

Except for subsection (c) section 332 corresponds to and in general restates section 112 (b) (6) of the 1939 Code and provides for the liquidation of a subsidiary corporation by its parent without the recognition of gain or loss to the parent corporation. Your committee has, however, deleted a provision which now appears in section 112 (b) (6) (A) which removes a liquidation from the application of that section if the parent corporation at some time on or after the time of the adoption of the plan of liquidation and until the receipt of the property owns more stock than that owned at the time of the receipt of the property. Your committee has removed this provision with the view to limiting the elective features of the section.

Subsection (c) of section 332 provides a special rule for treatment of the transfer of property in satisfaction of the indebtedness of a subsidiary to its parent in connection with a liquidation otherwise qualifying under section 332. In such case, subsection (c) provides that if a corporation is liquidated and the provisions of subsection (a) (i. e., sec. 112 (b) (6) of the 1939 Code) apply to such liquidation, and on the date of the adoption of the plan of liquidation such corporation was indebted to the parent corporation, then no gain or loss shall be recognized to the corporation so indebted because of the transfer of property in satisfaction of such indebtedness. This provision is intended to overrule I. T. 4109 (1952 C. B. 138) to the extent that the transfer of the property with respect to the indebtedness gives rise to gain or loss to the transferor subsidiary. Unlike the provisions of section 331 (c) (1) of the House bill, subsection (c) has no application as respects the tax treatment to the parent upon receipt of the asset in satisfaction of the indebtedness. In this connection, your committee intends that present law shall govern in the determining of the tax consequences of such transfer.

Section 333. Election as to recognition of gain in certain liquidations

This section incorporates section 112 (b) (7) of the 1939 code but makes it a permanent part of the law. At present it is not applicable to liquidations carried out in 1954. Under its most recent extension it applied to liquidations completed within one month during the calendar year 1953. As made permanent by your committee, the section will apply only in the case of plans of liquidation adopted on or after June 18, 1954. It is not necessary that the month of completion must fall within the taxable or calendar year in which the plan is adopted.

The principal effect of the section is to permit the receipt by qualified electing shareholders of property which has appreciated in value without the recognition of gain on such appreciation. In the case of individual distributees, to the extent gain is realized, any earnings and profits are treated as dividends, and the cash (or stock or securities acquired after August 15, 1950) is taxed at the rate applicable to capital gain. Corresponding provisions tax a corporate distributee at capital gain rates on the greater of:

(1) its share of the earnings of the liquidating corporation, or,

(2) cash (and stock and securities acquired after August 15, 1950).

While no basic change has been made in the operation of section 112 (b) (7) as it appears in section 333 of your committee's bill, it is to be noted that in paragraph (1) of subsection (e) the term "treated as a dividend" appears in lieu of the phrase "taxed as a dividend" presently utilized in section 112 (b) (7) of the 1939 Code. This language has been inserted in order to insure that the provisions of section 116 relating to partial exclusion of dividends received by individuals will be applicable to this section.

Section 334. Basis of property received in liquidations

Section 334 corresponds to existing law and to section 113 (a) (15), and section 113 (a) (18) of the 1939 Code and provides, in one section, rules for determination of the basis of property received in connection with the liquidation of a corporation under the various provisions of part II.

Subsection (a) sets forth the general rule to the effect that if property is received on a distribution in partial or complete liquidation and if gain or loss is recognized on receipt of such property, then the basis in the hands of the distributee shall be the fair market value of such property at the time of the distribution. The general rule of subsection (a) does not apply to a distribution to which section 332 or section 333 applies. While no statutory counterpart appears in the 1939 Code for the rule of subsection (a), this provision is intended to reflect present law in this area.

Subsection (b) corresponds in part to section 113 (a) (15) of the 1939 Code and relates to the basis of property in the case of the liquidation by a parent of its subsidiary corporation.

Paragraph (1) of subsection (b) sets forth the general rule that if property is received by a parent corporation in complete liquidation of its subsidiary in a transaction to which section 332 (a) applies then the basis of the property in the hands of the distributee parent shall be the same as it would be in the hands of the transferor subsidiary. A similar rule is adopted under paragraph (1) in the case of transfers of property in a distribution with respect to indebtedness to which section 332 (c) applies. This latter provision has been inserted to make clear that where a subsidiary transfers property to its parent in satisfaction of indebtedness owing to its parent, no increase or decrease in the basis of such property will result in consequence of the transfer. Such provision does not apply, however, in any case in which the basis of the property is determined under paragraph (2).

Paragraph (2) of subsection (b) incorporates into your committee's bill rules effectuating principles derived from *Kimbell-Diamond Milling Co.*, supra.

Paragraph (2) accordingly provides that if property is received by a corporation in a distribution in complete liquidation of its subsidiary then, provided the conditions of this paragraph are met, the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. The conditions that must be met are set forth in subparagraphs (A) and (B).

Subparagraph (A) provides that the distribution must be made pursuant to a plan of liquidation adopted on or after June 18, 1954, and not more than 2 years after the date of the acquisition of the requisite amount of stock referred to in subparagraph (B).

Subparagraph (B) requires that the distributee acquire by purchase during a period of not more than 12 months stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends). Your committee does not intend in this connection that the basis of property received by shareholders who are minority shareholders of the distributee shall be determined under subsection (b). The basis of property of such minority shareholders will, within the structure of part II, be determined under the general rule of subsection (a) of this section.

In ascertaining the adjusted basis of the stock with respect to which the distribution was made, for the purpose of paragraph (2), your committee intends that this phrase shall refer only to the adjusted basis of the stock properly adjusted for distributions made as dividends by the subsidiary to its parent prior to the adoption of the plan referred to in subparagraph (A) of subsection (b).

Paragraph (3) defines the term "purchase" to mean any acquisition of stock but only if the requirements of subparagraphs (A), (B), and (C) are met. Under subparagraph (A) it is intended to make clear that no purchase occurs where the stock is acquired and the basis of the stock in the hands of the distributee is determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or under section 1014 (a), relating to property acquired from a decedent. Thus, stock acquired in a transaction in which the basis is determined under section 362 will not be considered as stock which was acquired by purchase.

Subparagraph (B) makes clear that stock acquired in an exchange to which section 351 applies does not constitute stock acquired by purchase.

Subparagraph (C) provides that stock which is acquired from a person the ownership of whose stock would, under section 318 (a), be attributed to the person acquiring such stock does not qualify as stock which has been purchased.

In general, your committee intends to limit the definition of the term "purchase" to cases where the acquisition of the stock was made in a taxable transaction.

Paragraph (4) provides that for the purpose of subsection (b) the term "distributee" means only the corporation which meets the 80 percent stock ownership requirement specified in section 332 (b), i. e., the parent corporation.

Subsection (c) prescribes rules for the basis of property received in a transaction in which section 333 applies. This subsection constitutes a restatement of section 113 (a) (18).

SUBPART B—EFFECTS ON CORPORATION

Section 336. Effects on corporation, general rule

This section, for which there is no statutory counterpart under existing law, corresponds to section 308 (a) of the House bill and provides that no gain or loss shall be recognized to a corporation on the distribution of property in kind in partial or complete liquidation. This rule is derived from section 39.22 (a)-20 of Regulations 118. An exception to the application of this rule is provided, however, as respects the disposition of installment obligations under section 453 (d).

Section 337. Gain or loss on sales or exchanges in connection with certain liquidations

Section 337 corresponds in function to section 333 of the House bill and concerns the problems raised by the decisions in *Commissioner* v. *Court Holding Company*, 324 U. S. 451, and *U. S.* v. *Cumberland Public Service Co.*, 338 U. S. 341, and the numerous related cases. These decisions involve the question of whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. Under the decision in *Cumberland Public Service Co.*, supra, it is indicated that in the case of a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders, a single tax is imposed at the shareholder level. Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level. Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties. While the purpose intended to be served by section 337 is similar to that provided in section 333 of the House bill, the language and approach of section 337 differs from that of section 333.

Subsection (a) states the general rule of section 337 to the effect that if a corporation adopts a plan of complete liquidation on or after June 18, 1954, and the corporation, within the 12-month period beginning on the date of the adoption of the plan, disposes of all of the assets of the corporation (less assets retained to meet claims) in complete liquidation then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period. It is intended that all of the property except property retained to meet claims must be distributed by the corporation.

Subsection (b) defines the term "property" for purposes of section 337.

Subparagraph (A) provides that such term does not include stock in trade of the corporation or other property of a kind which would properly be included in the inventory of such corporation if on hand at the close of the taxable year and property held by the corporation primarily for sale to customers in the ordinary course of business.

Subparagraph (B) provides that "property" does not include installment obligations acquired in respect of the sale or exchange of stock in trade or other property described in subparagraph A. For the purpose of subparagraph (B) it is immaterial whether the sale or exchange occurred before, on, or after the date of the adoption of the plan of complete liquidation.

Subparagraph (C) provides that property does not include installment obligations acquired in respect of property (other than inventory) sold or exchanged before the date of adoption of the plan of liquidation.

Paragraph (2) of subsection (b) provides a special rule which would include inventory within the term "property" in any case in which substantially all of the inventory is, under section 337, sold or exchanged to one person in one transaction. In such case installment obligations acquired in respect of such sale or exchange are also included as property. It is intended that, during the 12-month period, sales in the ordinary course of business shall result in ordinary gain to the corporation as if the corporation were not in the process of liquidating. Your committee intends that where a bulk sale of the inventory assets is made at the beginning of the 12-month period, that no replacement of inventory or the acquisition of a new kind of inventory to conduct ordinary business for the balance of the 12-month period will be allowed. Thus, the bulk sale referred to will ordinarily be the last sale made by the corporation of its inventory. Installment obligations arising out of sales in the ordinary course of business shall be treated as inventory.

Subsection (c) limits the application of section 337. Paragraph (1) provides that this section shall not apply to any sale or exchange made by a collapsible corporation as defined in section 341 (b) or to sales by a corporation, if section 333 applies to the liquidation of such corporation. Paragraph (2) provides (A) that the section shall not apply to a liquidation under section 332 if the basis of the property in the hands of the distributee is determined under section 334 (b) (1) (corresponding to section 113 (a) (15) of the 1939 Code), and (B) that the section shall apply if the basis of property in the hands of the distributees is determined under section 334 (b) (2). In the latter case section 337 shall only apply to that portion of the gain arising from the sale of any asset which is not greater than the excess of that portion of the basis of the stock of the liquidating corporation in the hands of the distributee, allocated under regulations, to the property sold or exchanged, over the adjusted basis of such property. Example: In 1955, corporation X purchases all of the stock of corporation Y for $10,000. The sole asset of corporation Y is a building having a basis to corporation Y of $6,000. In 1956, corporation X causes the liquidation of corporation Y in a transaction to which section 332 (a) applies. During the course of liquidation the building is sold for $11,000. Of the aggregate gain of $5,000 realized in connection with the sale, section 337 applies to permit nonrecognition to $4,000 of such gain.

In connection with the application of subsection (c) the basis of the stock of the liquidating corporation in the hands of the distributee first be reduced by any reduction which may be required by reason of section 334 (b) (2), that is, where dividend distributions have been made by the subsidiary corporation to the parent.

Section 338. Effect on earnings and profits

This section contains a cross-reference to section 312 (e).

SUBPART C—COLLAPSIBLE CORPORATIONS; FOREIGN PERSONAL HOLDING COMPANIES

Section 341. Collapsible corporations

Your committee has revised the solution to the collapsible corporation problem which appears in the House bill. Under the House bill, so-called appreciated inventory retains its basis in the hands of the corporation in the event of liquidation and a tax on its full appreciation is recovered at the time of its disposition. The House bill permits sales of stock of what would be characterized as a collapsible corporation under existing law to be effected with capital-gain consequences to the selling shareholder.

Your committee's approach to the collapsible corporation problem is to return to existing law and to continue section 117 (m) for the future. Your committee writes into the section a provision now appearing in the regulations under this section and makes two substantial changes with a view to strengthening its effectiveness.

Subsection (a) (3) incorporates a rule of present regulations that would include gain from a distribution made by a collapsible corporation which under section 301 (c) (3) (A) is treated (to the extent it exceeds stock basis) as a gain from the sale or exchange of property and would provide that such excess be treated as the gain from the sale of property which is not a capital asset. This provision would apply, for example, in the case of a corporation engaged in building, and otherwise meeting the tests of a collapsible corporation, which distributes the proceeds of a loan in excess of the adjusted basis of the property by which the loan is secured. This rule supplements that previously described which appears in section 312 (j) of your committee's bill, relating to loans insured by the United States. Just as under section 312 (j), no inference is intended with respect to the status of present law by reason of the insertion into the statute of this rule.

Your committee has provided in subsection (b) (3) a definition of "section 341 assets." This definition is appropriate for purposes of the definition of a collapsible corporation in subsection (b) (1) and for purposes of the presumption in subsection (c), described later. Section 341 assets means property held for a period of less than 3 years and conforms to the definition of inventory assets previously described in connection with section 312 (b) (2), except for the addition of property described in section 1231 (b). Property described in section 1231 (b) (sec. 117 (j) of the 1939 Code) held for a period of less than 3 years is a section 341 asset except that the term does not include such property which is or has been used in connection with the manufacture, construction, production, or sale of certain other section 341 assets, such as inventory or property held primarily for sale to customers.

Subsection (b) (3) provides that in determining whether the 3-year holding period specified in the subsection has been satisfied, section 1223, providing for tacking in nontaxable exchanges, shall apply. The rule is also provided that no such holding period shall be deemed to begin before the completion of the manufacture, construction, production or purchase of the property.

Subsection (c) provides for a presumption that a corporation is a collapsible corporation if the fair market value of its "section 341 assets" as defined in subsection (b) (3) is 50 percent or more of the fair market value of its total assets and 120 percent or more of the adjusted basis of such "section 341 assets." It is intended that if either of the conditions described are not met a presumption that the corporation is not a collapsible corporation shall not arise. Subsection (d) provides that the section shall not apply to any shareholder owning less than 5 percent in value of the outstanding stock of the corporation. Under section 117 (m) of the 1939 Code the limit is 10 percent in value of the outstanding stock.

Section 342. Liquidation of certain foreign personal holding companies

This section is essentially the same as the corresponding language of section 115 (c) of the 1939 Code. However, subsection (b) provides a special rule for certain liquidations before 1956. It is therein provided that the general rule of the section shall not apply to a series of distributions in complete liquidation if the first distribution is made on or after June 18, 1954, and the final distribution is made before January 1, 1956. It is intended that the amount of gain resulting from such distribution shall be considered as the gain from the sale or exchange of a capital asset or property which is not a capital asset, as the case may be, whereas under subsection (a), the general rule, the gain would have been treated as gain from the sale or exchange of a capital asset held for not more than 6 months.

SUBPART D—DEFINITION

Section 346. Partial liquidation defined

This section provides rules for the determination of when a distribution by a corporation will be considered to be one in partial liquidation so that amounts distributed will be treated as in part or full payment in exchange for the stock under section 331 (a) (2), rather than as a distribution of property in redemption of stock to which section 302 applies which may be treated as a dividend to the extent of corporate earnings by reason of section 302 (d) and section 301.

Subsection (a) is intended to provide a definition of partial liquidation which replaces that contained in section 115 (i) of the 1939 Code. Primarily, this definition involves the concept of "corporate contraction" as developed under existing law. A distribution shall be treated as in partial liquidation if it is one of a series in redemption of all of the stock of a corporation pursuant to a plan or if the distribution is not essentially equivalent to a dividend and is in redemption of a part of the stock of a corporation pursuant to a plan of partial liquidation and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

It is intended that a genuine contraction of the business as under present law will result in partial liquidation. See, for example, Joseph Imler (11 T. C. 836). However, a distribution of a reserve for expansion is not a partial liquidation.

Subsection (b) provides a description of one kind of distribution which will be considered as being in partial liquidation. Paragraphs (1) and (2) contemplate that the distributing corporation must be engaged in the active conduct of at least 2 businesses which have been actively conducted (whether or not by it) for the 5-year period ending on the date of the distribution. Neither of such businesses may have been acquired within such period in a transaction in which gain or loss was recognized in whole or in part. Thus, a qualifying business may not have been acquired by purchase or in a corporate reorganization where so-called "boot" was present. If these requirements are met, one of the active businesses may be distributed in kind (or the proceeds of sale of such a business may be distributed) as long as the corporation immediately after the distribution is engaged in the active conduct of a business as described above. The determination of whether the requirements of subsection (b) have been met shall be made without regard to whether the distribution is pro rata among the shareholders of the corporation.

Under subsection (c) if a distribution to a shareholder qualifies under section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock), and also qualifies as a distribution in partial liquidation by reason of a corporate contraction, then any restriction upon the shareholder which would be imposed by any provision of section 302 shall not apply to such shareholder. For example, if a shareholder terminates his interest in a corporation pursuant to a partial liquidation in which he and his son each owned half the stock, there would be no sanction under section 302 (c) (2) (A) in the event of his reacquiring an interest in the corporation within 10 years from the date of the distribution.

Part III—Corporate Organizations and Reorganizations

GENERAL

Part III of subchapter C provides rules respecting corporate organizations, reorganizations, and distributions of stock of controlled corporations. The rules provided in this part are derived from sections 112 (b) (3), (4), (5), and (11), section 112 (c), (d), and (e), sections 112 (g), 112 (h), 112 (i), 112 (k) and sections 113 (a), (6), (7),

and (8) of the Internal Revenue Code of 1939. Section 112 (b) (2) of the 1939 Code, which did not appear in the House bill, has been reinstated by your committee and appears at section 1036.

One of the principal changes in your committee's bill is a modification of the rule of the *Groman* and *Bashford* cases (302 U. S. 82 (1947); 302 U. S. 454 (1938)). Under your committee's bill a transaction will be considered a reorganization when property is acquired by a subsidiary, the stock of the parent being used to make the acquisition. A transaction otherwise qualifying as a reorganization will nevertheless be considered a reorganization even though some or all of the assets acquired are immediately transferred to a subsidiary of the acquiring corporation.

Another change made by the House bill which is adopted by your committee is the elimination of the need for retention of proportionate control in the case of a transfer of property to a controlled corporation.

Your committee's proposed rules also permit the acquisition without recognition of gain or loss by one corporation of sufficient voting stock of another corporation to meet the control test (as defined in sec. 368 (c)) solely in exchange for its own voting stock in a case where the acquiring corporation already owns some of the stock of the other corporation. The acquisition without recognition of gain or loss of additional stock when control is already owned is likewise permitted.

Under present law if one corporation acquires substantially all the assets of another for its voting stock the acquisition must be made entirely for voting stock or the transaction will not be subject to the non-recognition rules to any extent. In the rules proposed by your committee such an acquisition will be permitted partly without recognition of gain or loss where it is made with voting stock equal in value to 80 percent of the value of all the assets of the transferor corporation, the remainder of the acquisition being made by the use of cash or other property.

Another change made by the House bill which is preserved by your committee is the provision that in certain cases in which property is transferred subject to a liability in excess of its basis, gain to the transferor shall be recognized to the extent that the liability exceeds the basis. Under the committee's bill such gain will be a capital gain or an ordinary gain as the case may be.

Section 353 of the House bill provides for the distribution tax free of the stock of controlled corporations. Your committee has restated this entire section restoring in large measure the rules of existing law. The primary change is the elimination of the requirement of the 1939 Code that such distribution be pursuant to a plan of reorganization. Certain other changes have also been made in existing law. These will be described below.

Under the Internal Revenue Code of 1939 all tax-free exchanges of stock and securities for stock and securities are referred to in section 112 (b) (3), while all tax-free distributions of stock in a so-called spin-off reorganization are referred to in section 112 (b) (11). Under your committee's bill, section 354 refers to all tax-free exchanges of stock and securities in reorganizations other than a divisive reorganization. On the other hand, section 355 refers to all exchanges and distributions of stock and securities in cases in which the businesses owned by a single corporation (either directly or indirectly) are owned by two or more corporations after the distribution.

Section 351. Transfer to corporation controlled by transferor

This section is derived from section 112 (b) (5) and section 112 (c) and (e) of the Internal Revenue Code of 1939 and is generally similar to section 351 of the House bill. The Internal Revenue Code of 1939 provides that transfers of property to a controlled corporation are tax free only if immediately after such transfers the persons transferring the property receive stock and securities substantially in proportion to their interests in the property prior to the transfer. The House bill eliminates this so-called "proportionate interest" test and also provides that services shall not be considered property for purposes of this section. Your committee has accepted these changes.

The "proportionate interest" requirement, which appears in section 112 (b) (5) of the 1939 Code, permits nonrecognition of gain and loss only if the stock and securities received by each transferor are "substantially in proportion" to the interest of such transferor in the property prior to the exchange. This requirement, which, if unsatisfied, serves to vitiate the tax-free nature of the entire transaction, caused considerable uncertainty in its application. In eliminating the proportionate interest test, your committee intends that no gain or loss will be recognized to a transferor transferring property to a corporation under section 351, irrespective of any disproportion of the amount of stock or securities received by him as a result of the transfer. Thus, if M and N each owning property having a value of $100 transfers such property to a newly formed corporation X, and M receives all of the stock, such transaction would not be subject to tax under section 351. To the extent, however, that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature. For example, if individuals A and B, father and son, organize a corporation with 100 shares of common stock and A transfers property worth $80 in exchange for 20 shares of stock, while B transfers property worth $20 to the corporation in exchange for 80 shares of stock, no gain or loss will be recognized under section 351. If, however, it is determined that in fact A has made a gift to B, it is your committee's intention that such gift would be subject to tax under the provisions of section 2501 and following. Similarly, if, in the preceding example, B had rendered services to A and the disproportion in the amount of stock received constituted, in effect, the payment of compensation by A to B, it is your committee's intention that such compensation will be appropriately taxed. B will be taxable upon the fair market value of the 60 shares of stock received in excess of that received in exchange for his property as an amount received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis of the 60 shares of stock in his hands and its fair market value.

In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind.

An amendment has been made by your committee to section 351 of the House bill. Under the Internal Revenue Code of 1939, if the transferors in a transaction to which section 112 (b) (5) was applicable were corporations it was not clear whether a distribution of the stock received by such transferors would prevent the application of such section. Section 351 (c) provides specifically, that if a corporate transferor distributes the stock received this will not prevent the application of section 351. For this purpose it is immaterial whether such a distribution by the transferor is taxable as an ordinary dividend, is taxable at capital gain rates, or is tax free. As under existing law, if other property is received no loss is recognized and gain is recognized only to the extent of the property other than stock or securities received by the transferor in exchange for the property transferred.

SUBPART B—EFFECTS ON SHAREHOLDERS AND SECURITY HOLDERS

Section 354. Exchanges of stock and securities in certain reorganizations

The House bill abolished the requirement of an exchange by a shareholder or security holder as a condition to nonrecognition of gain or loss in connection with a reorganization and treated all distributions and exchanges in the same manner, your committee provides rules for stock and security exchanges in reorganizations other than in divisive reorganizations under section 368 (a) (1) (D). These rules are the same as under existing law and are stated in substantially the same form. Thus, section 354 provides rules for exchanges by shareholders and security holders in reorganizations described in sections 368 (a) (1) (A), (B), (C), (E), and (F). Exchanges in reorganizations under section 368 (a) (1) (D) are included only when the transferor corporation transfers substantially all of its assets to a single transferee corporation. It will be noted that section 354 applies to a transaction in which one corporation acquires the stock of another under the terms of section 368 (a) (1) (B). Except for this, subsections 354 (a) and (b) apply only to recapitalizations and transactions in which all or substantially all of the assets of one corporation are transferred to a single transferee corporation.

Section 354 (a) is derived from section 112 (b) (3) of the Internal Revenue Code of 1939, but makes clear that securities may only be received tax free in an amount not in excess of the principal amount of securities surrendered. If securities in any greater amount are received the fair market value of the excess amount is treated as other property. Likewise, if securities are received and no securities are surrendered such securities are treated as other property.

Section 354 (b) provides that section 354 shall only apply to an exchange pursuant to a reorganization under section 368 (a) (1) (D) when property is transferred to a single transferee corporation and when the transferor distributes all of the stock and securities received as well as all its other property in pursuance of the plan of reorganization.

Section 354 (c) states a special rule for certain railroad reorganizations approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act or under section 20 (b) of the Interstate Commerce Act as being in the public interest.

Section 355. Distribution of stock and securities of a controlled corporation

Section 355 corresponds to that portion of section 112 (b) (3) of the 1939 Code which relates to divisive reorganizations of corporations including "split-ups" and "split-offs" and to section 112 (b) (11) of such code relating to corporate "spin-offs." Section 355 is also directly related to section 368 (a) (1) (D) which is derived from 112 (g) (1) (D) of the 1939 Code. As under existing law and the House bill, distributions of stock may be tax free without any exchange in certain cases.

Your committee has, in addition, accepted certain changes made in the House bill with respect to sections 112 (b) (3), 112 (b) (11), and 112 (g) (1) (D). Thus, the House bill and your committee abolish the requirement of a reorganization in connection with the distribution of stock of a controlled corporation, thereby eliminating the necessity of creating a holding company in order to distribute such stock without the recognition of gain or loss. Likewise, the House bill and your committee provide for the non-pro rata distribution of stock of a controlled corporation.

In addition, provision is made by your committee permitting the retention by the distributing corporation of stock and securities of a controlled corporation provided stock constituting control is distributed and it is established to the satisfaction of the Secretary that it is not pursuant to a plan having as one of its principal purposes the avoidance of Federal income tax.

Subsection (a) (1) sets forth the general rule that no gain or loss shall be recognized to a shareholder or security holder on the receipt of stock or securities of a controlled corporation. Certain specific limitations are set forth in paragraph (3) of subsection (a) and in the remainder of subsection (a) (1).

Under subparagraph (A) of paragraph (1) the distribution must consist solely of stock or securities. If additional property is distributed, section 356 will apply.

Subparagraph (B) of paragraph (1) provides that, to obtain the tax-free treatment under section 355, the transaction must not be used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both.

Subparagraph (C) of paragraph (1) requires that the rules in subsection (b), relating to active businesses, be satisfied.

Subparagraph (D) of paragraph (1) requires that in order for a transaction to qualify under section 355, the distributing corporation must distribute either all of the stock and securities of the controlled corporation, or an amount of stock constituting control within the meaning of section 368 (c) (i. e., 80 percent of the voting power and total number of shares), and the Secretary must be satisfied that no avoidance of taxes was intended. This requirement is a change from present law and the House bill.

Paragraph (2) of subsection (a) makes clear that paragraph (1) applies regardless of the presence of certain factors.

Subparagraph (A) of paragraph (2) provides that paragraph (1) applies whether the distribution is pro rata with respect to all of the shareholders of the distributing corporation. An example of this type of distribution would be a divisive split-up, through the distribution of stock of two new controlled corporations to which all the assets of the original corporation had been transferred, made pursuant to an antitrust decree. Similarly, if two individuals, A and B, jointly form a corporation and later wish to operate independently through separate corporations, this may be accomplished under section 355, provided all of the other requirements of this section are satisfied.

Subparagraph (B) of paragraph (2) provides that paragraph (1) shall apply whether or not the shareholder surrenders stock in the distributing corporation. This corresponds in function to section 112 (b) (11) of the 1939 Code. However, the rule of existing law is changed to permit the distribution of both common and preferred stock without the surrender of stock in the distributing corporation. The application of section 306 to the receipt of such preferred stock is necessary in order to determine whether such stock would be designated "section 306 stock."

Subparagraph (C) of paragraph (2) provides that paragraph (1) shall apply whether or not the distribution is in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D). Under present law, for section 112 (b) (11) to be applicable there must be a reorganization as defined in section 112 (g) (1) (D) and a distribution to shareholders in pursuance of the plan of reorganization. Because of the elimination of the requirement that there be a reorganization, it is no longer necessary for the distributing corporation to form a holding company to effect the distribution. It is to be noted that the House bill, which placed no restrictions as respects the act of distribution upon the nature of the activities of the corporation the stock of which is distributed, has been changed. The requirements as to active businesses are discussed in subsection (b).

Paragraph (3) of subsection (a) contains the limitations upon the application of paragraph (1), which are as follows:

Subparagraph (A) of paragraph (3) provides that paragraph (1) shall not apply if the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution. Such excess is treated as "other property" for purposes of section 356 to the extent of the fair market value of such excess. By thus limit ng taxation of securities to the fair market value of the amount of the excess principal amount received, a principle analogous to *Commissioner* v. *Neustadt's Trust* (131 F. 2d 528 (C. C. A. 2, 1942)) is effectuated.

Subparagraph (B) makes it clear that if secur ties are received and no securities are surrendered, paragraph (1) shall not apply to the receipt of such securities. The fair market value of such securities is treated as "other property" under section 356.

For purposes of determining the taxable nature of part of the exchange or distribution, stock in a controlled corporation acquired by purchase within 5 years of its distribution is treated as "other property". Thus, for example, if a corporation has held a minority stock interest in a corporation for 5 years or more prior to the distribution and within such 5-year period purchases control of such corporation only the stock so purchased will be considered "other property" if the stock of the subsidiary is distributed in a distribution which otherwise meets the requirement of the statute. However, stock so purchased is nevertheless "stock" for purposes of the requirements respecting the distribution of stock of such controlled corporation provided in section 355 (a) (1) (D). It is to be noted (as is indicated in the cross reference in paragraph (4)) that in any case in which "other property" is received in addition to stock and securities permitted to be received by this section, such distribution will be governed by section 356.

Subsection (b) contains rules with respect to active business requirements.

Subparagraph (A) of paragraph (1) requires that in order for subsection (a) to be applicable, the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business. If the stock of more than one controlled corporation is distributed, each of such corporations must meet this requirement.

Subparagraph (B) provides that subsection (a) shall also be applicable if immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business. An example of this type of distribution would be either a prorata or nonprorata split-up. It is assumed that in connection with the requirement of "no asset" a de minimis rule will be applied.

Paragraph (2) sets forth the rules for the determination of whether a corporation qualifies as being engaged in the active conduct of a trade or business for purposes of paragraph (1) of subsection (b). A corporation shall be treated as engaged in the active conduct of a trade or business if it is so engaged or if substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged.

Subparagraph (B) provides that for purposes of subsection (b) (1) a corporation shall be treated as engaged in the active conduct of a trade or business only if such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution. Where such trade or business was acquired in a taxable exchange the period of time such trade or business was actively conducted by the predecessor may be used in determining whether the 5-year period requirement is met.

Subparagraph (C) requires that in order for subsection (b) (1) to be applicable the trade or business must not have been acquired within the 5-year period ending on the date of the distribution in a transaction in which gain or loss was recognized in whole or in part.

Section 356. Receipt of additional consideration

Section 356 corresponds to section 112 (c) and 112 (e) of the 1939 Code and retains to a large extent the language of such sections. The treatment of securities is clarified by the adoption of a principle analogous to that found in *Commissioner* v. *Neustadt's Trust* (131 F. 2d 528 (C. C. A. 2, 1942)). The method adopted under section 306 of the House bill of correlating "boot" distributions made incident to a corporate reorganization and property distributions generally, has been abandoned.

Subsection (a) corresponds to section 112 (c) of the 1939 Code and is identical in substance with that section.

, Subsection (b) relates to the treatment of "boot" in a distribution (without an exchange) to which section 355 would apply except for the receipt of other property or "boot." In such case the amount of money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

Subsection (c) corresponds in substance to section 112 (e) of the 1939 Code and provides similarly for nonrecognition of loss in a transaction in which "boot" is received.

Subsection (d) contains rules as to the treatment of securities for purposes of section 356. Paragraph (1) states the general rule that for purposes of section 356 the term "other property" includes securities. This is a restatement of the principle stated by the Supreme Court in *Bazley* v. *Commissioner* (331 U. S. 737; 1948).

The exceptions to paragraph (1) are contained in paragraph (2). Subparagraph (A) provides that the term "other property" does not include securities permitted under sections 354 and 355, to be received tax free. Thus, where securities are surrendered in a transaction to which section 354 or section 355 is applicable, the characterization of the securities received as "other property" does not include securities received where the principal amount of such securities does not exceed the principal amount of securities surrendered in the transaction.

Subparagraph (B) of paragraph (2) states rules with respect to the treatment of securities received in a section 354 exchange where the principal amount of the securities received exceeds the principal amount of securities surrendered. The characterization as "other property" is limited to the fair market value of any excess of the principal amount of securities received over the principal amount of securities surrendered. If no securities are surrendered, the excess shall be the entire principal amount of securities received.

Subparagraph (C) of subsection (d) (2) states rules with respect to the treatment of securities as "other property" in an exchange or distribution to which section 355 is applicable. The categorization as "other property" is limited to the fair market value of the excess of the principal amount of securities received over such securities surrendered. If no securities are surrendered, the excess shall be the entire principal amount.

Subsection (e) provides rules with respect to the treatment of property received in exchange for section 306 stock. This subsection provides that if other property or money is received for section 306 stock, the payment of such property or money shall be treated as a distribution to which section 301 applies. For example, if a shareholder surrenders section 306 stock for $100 cash, the $100 will be treated as a distribution to which section 301 applies and will be included in income under section 301 (c) to the extent of the earnings and profits of the corporation at the time of distribution. The question of whether section 306 stock is surrendered for cash or other property is a question of fact to be decided under the circumstances of each case. Ordinarily, the other property received will first be applied against the section 306 stock. However, such other property will not be applied against section 306 stock in any case in which the taxpayer establishes that the facts of the transaction are such that the other property was not surrendered for such section 306 stock.

Section 357. Assumption of liability

Section 357, relating to the treatment of the assumption of a liability or the acquisition of property subject to a liability, is similar to section 112 (k) of existing law. However, subsection (c) has no counterpart under the 1939 Code, but did appear in substance in the House bill. The language of subsection (b), relating to assumption of liability for tax avoidance purpose has been changed in one respect from existing law. Where such a tax avoidance purpose exists, the total amount of the liabilities assumed will be considered as money received by the taxpayer and not merely a particular liability with respect to which the tax avoidance purpose existed. This change is intended merely to clarify existing law.

Subsection (c) provides that if in an exchange to which section 351 (relating to a transfer to a corporation controlled by the transferor) is applicable or to which section 361 (relating to the nonrecognition of gain or loss to corporations) is applicable by reason of a section 368 (a) (1) (D) reorganization, if the sum of the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be. Thus, if an individual transfers, under section 351, property having a basis in his hands of $20,000, but subject to a mortgage of $50,000, to a corporation controlled by him, such individual will be subject to tax with respect to $30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor.

It is to be noted the House bill in this connection imposed a tax at capital gains rates even though the assets to which the liabilities are subject were, in whole or in part, assets other than capital assets within the meaning of this subtitle. The determination of whether a gain resulting from the transfer of capital assets is long- or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred. For example, if all of such assets transferred are capital assets and if half of the assets (ascertained by reference to their fair market value at the time of the transfer) have been held for less than 6 months and the remaining half of the assets have been held for more than 6 months, half of the excess of the amount of the liability over the adjusted basis of the property shall be taxed as short-term capital gain, and the remaining half shall be taxed as long-term capital gain.

An exception to the general rule of paragraph (1) of subsection (c) is made for any exchange as to which under subsection (b) (1) of this section the entire amount of the liability is treated as money received or for an exchange to which section 371 (relating to reorganizations in certain receivership and bankruptcy proceedings) is applicable.

Section 358. Basis to distributees

Section 358 restates in general the substance of section 113 (a) (6) of the 1939 Code. Certain structural changes have been made in this section to conform to the pattern of part III. In addition a special rule has been added to clarify the basis consequences resulting from the receipt of "other property" in exchange for section 306 stock in a transaction to which part III applies.

Subsection (a) sets forth the general rule and enumerates the sections (secs. 351, 354, 355, 361, or 371 (b)) to which this section applies.

Paragraph (1) provides that the basis of property (including stock or securities) permitted to be received without the recognition of gain or loss shall be the same as that of property exchanged, decreased by the fair market value of any other property and the amount of any money received by the taxpayer and increased by the amount treated as a dividend and the amount of any gain which was recognized on the exchange. The increase required by the amount of any recognized gain does not for the purpose of paragraph (1) include any portion of any gain which was treated as a dividend.

The reference in paragraph (1) to an amount which was "treated as a dividend" does not appear in section 113 (a) (6) of the 1939 Code and is included primarily to take into account the fact that "other property" received in an exchange for section 306 stock under part III is specially taxed.

Paragraph (2) determines that the basis of any "other property" received by the taxpayer shall be its fair market value.

Section 358 (b) provides that where several kinds of stock or securities are received, the Secretary may prescribe rules for the allocation of the basis among them. This provision for allocation is also made applicable to cases in which only part of the stock owned is exchanged.

Section 358 (c) provides that when stock is received in a tax-free distribution of stock of a controlled corporation, the basis of the old and new stock shall be determined in a manner similar to that applicable to an exchange.

Section 358 (d) provides that where a liability is assumed, the amount of such liability shall be considered as money received. This is a restatement of existing law.

Section 358 (e) provides, as does existing law, that the entire section shall not apply to property acquired by a corporation by the issuance of the stock or securities as consideration in whole or in part for the transfer of property to it.

SUBPART C—EFFECTS ON CORPORATION

Section 361. Nonrecognition of gain or loss to corporations

Section 361 corresponds to sections 112 (b) (4), 112 (d), and 112 (e) of the Internal Revenue Code of 1939.

Section 362. Basis to corporations

Section 362, corresponding generally to section 113 (a) (7) and section 113 (a) (8) of the 1939 Code and to section 355 of the House bill provides rules respecting the basis of property acquired on or after June 18, 1954, by a corporation in connection with a corporate organization, as paid in surplus, as a contribution to capital, or in connection with a reorganization to which this part applies. A new provision has been added (subsec. (c)) relating to contributions to capital in certain cases by persons other than shareholders.

Subsections (a) and (b) are identical in substance with sections 113 (a) (8) and 113 (a) (7) of the present code. Subsection (c) has no counterpart under existing law, but is similar to section 355 (c) of the House bill. This subsection provides rules respecting situations similar to that which occurred in *Brown Shoe Co.* v. *Commissioner* (339 U. S. 583). Paragraph (1) of subsection (c) provides, that in such a case, if property, other than money, is acquired by a corporation after June 18, 1954, as a contribution to capital and is not contributed by a shareholder as such, then the basis of such property to the corporation shall be zero.

Paragraph (2) of subsection (c) provides that if money is received by a corporation, after June 18, 1954, as a contribution to capital and such money is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12 months' period beginning on the day the contribution is received shall be reduced by the amount of the contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied in reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the corporation. The particular properties to the bases of which the reduction shall be allocated shall be determined under regulations prescribed by the Secretary.

The House bill referred to gifts made to a corporation. Although no change in substance is intended, your committee believes that such reference is unnecessary.

Section 363. Effect on earnings and profits

This is a cross-reference section.

SUBPART D—SPECIAL RULE; DEFINITIONS

Section 367. Foreign corporations

Section 367 is derived from, and corresponds in function to section 112 (i) of the Internal Revenue Code of 1939. Such changes in language as have been made in section 367 as compared with section 112 (i), are not intended to change the existing application of section 112 (i).. Under the provisions of section 367 in determining the extent to which gain shall be recognized in the case of any exchanges described in section 332 (relating to liquidations of subsidiaries), section 351 (relating to corporate organizations), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 355 (relating to the distribution of stock and securities of a controlled corporation), section 356 (relating to the receipt of additional consideration in certain exchanges or distributions), or section 361 (relating to the nonrecognition of gain or loss to corporations), a foreign corporation shall not be considered as a corporation unless before such exchange, it has established to the satisfaction of the Secretary that such an exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of section 367 any distribution described in section 355 (or so much of sec. 356 as relates to sec. 355) shall be treated as an exchange whether or not it is an exchange.

Section 368. Definitions relating to corporate reorganizations

In lieu of section 359 of the House bill which describes three types of transactions referred to as "corporate acquisitions of property," "corporate acquisitions of stock," and "separations," section 368 of your committee's bill makes use of the expression "reorganization" used in the existing statute. This section corresponds to sections 112 (g) (1), 112 (g) (2), and 112 (h) of existing law.

Section 368 corresponds to sections 112 (g) (1), 112 (g) (2), and 112 (h) of existing law.

Subsection (a) (1) restates the definitions of section 112 (g) (1) of the Internal Revenue Code of 1939. Three of these definitions, those in pars. (A), (E), and (F), provide that the term "reorganization" includes a statutory merger or consolidation (A), a recapitalization (E), or a mere change in identity, form, or place of organization (F).

Under section 112 (g) (1) (B), of existing law, one corporation can acquire enough stock of another to get control of the second corporation solely for its own voting stock tax free. However, there is doubt as to whether the existing statute permits such an acquisition tax free when the acquiring corporation already owns some of the voting stock of the other corporation. This doubt is removed by your committee's bill and paragraph (B) of subsection (a) (1) permits such an acquisition tax free (in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months). For example, corporation A purchased 30 percent of the common stock of corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, corporation A offers to exchange its own voting stock, for all of the stock of corporation W tendered within 6 months from the date of the offer. Within the 6 months period corporation A acquires an additional 60 percent of the stock of W for its own voting stock. As a result of the 1955 transactions, corporation A will own 90 percent of all of corporation W's stock. No gain or loss is recognized with respect to the exchanges of the A stock for the W stock. For this purpose it is immaterial whether such exchanges occurred before corporation A acquired control of W (80 percent) or after such control was acquired. If corporation A had acquired 80 percent of corporation W's stock for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

Subparagraph (C) of subsection (a) (1) corresponds to section 112 (g) (1) (C) of the 1939 Code relating to the acquisition by one corporation, without the recognition of gain or loss, of substantially all of the properties of another corporation in exchange for part or all of the voting stock of the acquiring corporation. The rule of this subparagraph is intended to modify the rule of *Groman* v. *Commissioner* (320 U. S. 82) and *Helvering* v. *Bashford* (320 U. S. 454). Under subparagraph (C) a corporation may acquire substantially all the properties of another corporation solely in exchange of the voting stock of a corporation which is in control of the acquiring corporation. For example, corporation P owns all the stock of corporation A. All the assets of corporation W are transferred to corporation A solely in exchange for the voting stock of corporation P. Such a transaction constitutes a reorganization under subparagraph C.

Subparagraph (D) of subsection (a) (1) restates the definition of existing law appearing in section 112 (g) (1) (D) of the Internal Revenue Code of 1939. Under this definition the term "reorganization" includes a transfer by a corporation of all or a part of its assets to another corporation if immediately after such transfer the transferor corporation, or its shareholders, or both, are in control of the transferee.

Your committee's bill has altered the definition to provide that if the control of the transferee corporation is in the transferor corporation or in persons who were shareholders of the transferor, or any combination thereof, the transfer will, nevertheless, qualify as a reorganization under section 368 (a) (1) (D), the control owned by these persons need not be in the same proportion as it was before the transfer. For example, corporation A owns only properties connected with a drug store and a hardware store. Corporation A transfers the drug store properties to corporation D in exchange for all the stock of D and transfers the hardware store properties to corporation H in exchange for all the stock of H. Immediately thereafter, corporation A distributes all the stock in corporation D to X, one of the two shareholders in A, in exchange for all of X's stock and distributes all the stock in corporation H to Y, the other shareholder in A, in exchange for all his stock. The distributions qualify under section 355. The transfer of the properties by A is a reorganization under subparagraph (D). It should be noted, however, that in the event that the values of the properties transferred to corporations D and H are disproportionate to the value of the stock in A held by shareholders X and Y, the transaction at the shareholder level may have the effect of a gift or a compensation. See section 355.

Subparagraph (D) also explicitly states that a transaction of the type described is only to be considered a reorganization when the stock and securities of the transferee corporation or corporations are distributed to the shareholders and security holders under the terms of section 354, 355, or 356. However, where there is no such distribution, the transaction may, nevertheless, result in nonrecognition of gain or loss to the transferor corporation under the terms of section 351.

Paragraph (2) of subsection (a) lists three special rules which modify existing law. It is provided that if a transaction meets the description, both of an acquisition of assets for stock (subsec. (a) (1) (C)) and also meets the description of a transfer to a controlled corporation (subsec. (a) (1) (D)) it shall be treated as described only in subsection (a) (1) (D).

Your committee intends by this rule to insure that the tax consequences of the distribution of stocks or securities to shareholders or security holders in connection with divisive reorganizations will be governed by the requirements of section 355 relating to distribution of stock of a controlled corporation.

Paragraph (2) (B) provides that where one corporation acquires substantially all the property of another (subsection (a) (1) (C)) if at least 80 percent of the fair market value of all the property of the other corporation is acquired solely for voting stock, the remainder of the property acquired may be acquired for cash or other property without disqualifying the transaction as a reorganization. For this purpose only, a liability assumed or to which the property is subject, is considered other property. For example, corporation A has assets worth $100,000 and $10,000 in liabilities. Corporation Y acquires $98,000 worth of assets subject to a liability of $10,000. In exchange for these assets, corporation Y transfers its own voting stock, assumes the $10,000 liability, and pays $8,000 cash. This transaction is a reorganization even though a part of the assets of corporation A is acquired for cash. On the other hand, if the assets of corporation A, worth $100,000, were subject to $50,000 in liabilities, an acquisition of all of the assets subject to the liabilities could only be in exchange for voting stock because the liabilities alone are in excess of 20 percent of the fair market value of the property. Thus, only the rule of subsection (a) (1) (C) could be applicable.

Subparagraph (C) of paragraph (2) provides that if one corporation acquires all, or substantially all, of the assets of another corporation in a reorganization qualifying under section 368 (a) (1) (A) or (C), the acquisition will not fail to be a reorganization merely because the acquiring corporation transfers some or all of these assets to a corporation controlled by it. This subparagraph is intended to give further clarification in the area treated in the Groman and Bashford cases, supra.

Subsection (b) of section 368 defines a "party to a reorganization." It reinstates existing law as now appearing in section 112 (g) (2), and in addition provides (with respect to the area of the Groman and Bashford cases, supra) that the corporation controlling the acquiring corporation is also a party to the reorganization when the stock of such controlling corporation is used to acquire assets. It also provides that a corporation remains a party to the reorganization although it transfers all or part of the assets acquired to a controlled subsidiary.

Subsection (c) of section 368 defines "control" in the same manner as section 112 (h) of the Internal Revenue Code of 1939 and section 359 (c) of the House bill.

Part IV—Insolvency Reorganizations

Sections 371 to 373

These sections repeat sections 112 (b) (9) and (10) of the present code, relating to insolvency reorganizations, by railroad and other corporations, together with their related basis and treatment of shareholder provisions. The principal effect of these sections is to preserve to a corporation undergoing an insolvency reorganization in a court proceeding the historic basis of its assets. These provisions were also contained in the House bill. In both your committee's bill and the House bill, the rule of section 112 (c) (2) of the 1939 Code which permits the taxation as a dividend of "boot" received in a reorganization under certain circumstances has been removed from application in the area of insolvency reorganizations.

Part V—Carryovers

Section 381. Carryovers in certain corporate acquisitions

Your committee has retained, with some additions and technical changes, the section in the House bill establishing statutory provisions for the carryover of items or tax attributes from a corporation distributing or transferring its property to another corporation in a liquidation or reorganization described in subsection (a).

The term "carryover" as used in this section refers to the utilization of any one or more of the tax attributes covered by this section. Unless preceded by "net operating loss," the term does not necessarily refer to a net operating loss carryover.

Subsection (a) describes the corporate liquidations and reorganizations which result in the carryover to the acquiring corporation of the items specified in subsection (c). This includes the complete liquidation of a subsidiary (unless the basis of the assets distributed to the parent corporation is determined under section 334 (b) (2)) and the reorganizations specified in paragraph (2) of subsection (a). The section does not apply to partial liquidations or to divisive or other reorganizations not specified in subsection (a).

Throughout the section, frequent use is made of the terms distribution, distributor corporation, transfer, transferor corporation, and acquiring corporation. Distribution is used in connection with a complete liquidation of a subsidiary corporation and distributor corporation is used to denote the subsidiary. Transfer is used in connection with any reorganization specified in subsection (a) (2) and transferor corporation is used to denote the corporation which merges into, consolidates with, or otherwise transfers its property to another corporate entity. Acquiring corporation refers to the successor corporation in either a liquidation or reorganization specified in subsection (a).

Subsection (b) contains operating rules which are applicable to the liquidations and reorganizations specified in subsection (a) except a reorganization described in subparagraph (F) of section 368 (a) (1). Under subsection (b) (1) of this section, the corporation making a distribution or transfer of property must end its taxable year on the date of distribution or transfer. If the distribution or transfer is not completed in one day, the date of distribution or transfer is, as provided in subsection (b) (2), the day on which the distribution or transfer is completed, except that, under regulations, the date when substantially all the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such date.

Paragraph (3) of subsection (b) provides that an acquiring corporation to which property is distributed or transferred in a corporate transaction described in paragraphs (1) and (2) of subsection (a) (except a reorganization described in subparagraph (F) of section 368 (a) (1)) is not entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation. For example, assume corporations X and Y transfer on December 31, 1954, all their property to Z in a transaction described in subparagraph (A) of section 368 (a) (1). If Z has a net operating loss in 1955, such loss cannot be carried back to a taxable year of X or Y. Or, assume corporation X merges into corporation Y on December 31, 1954, in a statutory merger with Y's charter continuing after the merger. If Y has a net operating loss in 1955, such loss cannot be carried back to a taxable year of X but shall be a carryback to a taxable year of Y. If, however, corporation X, in a reorganization described in subparagraph (F) of section 368 (a) (1), merely changes its identity, form, or place of organization, the resulting corporation is entitled to carry back its net operating loss to a taxable year of X prior to the reorganization.

Subsection (c) of this section contains 18 paragraphs, each of which specifies an item or tax attribute of the distributor or transferor corporation which is to be taken into account by the acquiring corporation as of the close of the date of distribution or transfer in the manner and to the extent provided with respect to such item. The section is not intended to affect the carryover treatment of an item or tax attribute not specified in the section or the carryover treatment of items or tax attributes in corporate transactions not described in subsection (a). No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law.

Paragraph 1 of subsection (c) contains the conditions and limitations on the carryover of the net operating losses for loss years of the distributor or transferor corporation. Subparagraph (B) contains a limitation on the amount of the net operating loss deduction attributable to net operating losses for loss years of the distributor or transferor corporation which is deductible in the first taxable year ending after the date of distribution or transfer.

For the purpose of determining the amount of a net operating loss for a loss year of either the distributor corporation, transferor corporation, or the acquiring corporation which is a carryover to taxable years following the taxable year specified in subparagraph (A), the taxable income of the taxable year specified in subparagraph (A) is determined under section 172 (b) (2), subject to the conditions and limitations imposed in subparagraph (C). Under this subparagraph, a net operating loss for a loss year of the distributor or transferor corporation which ends on or before the end of a loss year of the acquiring corporation is considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. If the date of distribution or transfer is on any day other than the last day of the acquiring corporation's taxable year, the provisions of clauses (i) to (vi), inclusive, must be followed in determining the amount of a net operating loss which is a carryover to a subsequent taxable year. These clauses separate the taxable year in which the date of distribution or transfer falls into two parts, which are treated as taxable years solely for the purpose of subparagraph (C). A net operating loss carryover from a loss year of the acquiring corporation is first carried to the pre-acquisition part year and then the remainder, if any, is carried to the post-acquisition part year. For the purpose of determining under section 172 (b) (1) the years to which a net operating loss for a loss year of the acquiring corporation is carried, the pre-acquisition part year and the post-acquisition part year are together treated as only 1 taxable year.

For example, assume corporation X was organized January 1, 1953, and had net operating losses in the calendar years 1953 and 1954 of $10,000 and $15,000, respectively. Corporation Y was organized January 1, 1952, and had net operating losses in the calendar years 1952, 1953, and 1954 of $7,000, $10,000, and $25,000, respectively. On July 4, 1955, Y transfers all its property to X in a transaction described in subsection (a) (2), and ends its taxable year with $1,000 taxable income before considering the net operating loss deduction. It has no modifications specified in section 172 (b) (2) (A) for such taxable year. X has taxable income of $36,500 for 1955 before considering the net operating loss deduction and also has modifications specified in section 172 (b) (2) (A) of $365.

X's net operating loss deduction for 1955 is:

	Net operating loss carryover
Y's 1952	[1] $6,000
Y's 1953	10,000
X's 1953	10,000
Y's 1954	[2] 2,000
X's 1954	15,000
	43,000

[1] Y's 1952 net operating loss of $7,000 would first offset Y's income of $1,000 for the taxable year ended July 4, 1955, and hence, would be a net operating loss carryover of $6,000 to X for 1955.

[2] Subpar. (B) limits the portion of X's net operating loss deduction in 1955 attributable to net operating loss carryovers from Y to (180/365 of $36,500) $18,000. Since Y had net operating loss carryovers of $6,000 and $10,000 from years prior to 1954, Y's 1954 net operating loss carryover of $25,000 is limited in 1955 to $2,000.

In computing the net operating loss carryovers to 1956, subparagraph (C) requires the 1955 taxable income (computed with the modifications specified in section 172 (b) (2) (A)) to be divided in two parts, each of which is treated as a taxable year for this purpose only. Thus $^{185}/_{365}$'s of $36,500+$365, or $18,685, is allocated to the pre-acquisition part year and $^{180}/_{365}$'s of $36,500+$365, or $18,180, is allocated to the post-acquisition part year. Only net operating losses for X's loss years can be used against the pre-acquisition part year income. X's 1953 net operating loss would be treated as follows:

Net operating loss	$10,000
X's pre-acquisition part year income computed under sec. 172 (b) (2) and subpar. (C)	−18,685
No net operating loss carryover to the post-acquisition part year or any subsequent year	-------

X's 1954 net operating loss would be treated as follows:

Net operating loss	$15,000
X's pre-acquisition part year income computed under sec. 172 (b) (2) and subpar. (C)	[1] −8,685
Net operating loss carryover to post-acquisition part year	6,315
X's post-acquisition part year income computed under sec. 172 (b) (2) and subpar. (C)	[2] −0
Net operating loss carryover to 1956	6,315

[1] X's pre-acquisition part year income of $8,685 is determined as follows:

Divided portion of income computed with modifications specified in sec. 172 (b) (2) (A)	$18,685
Net operating loss deduction computed under sec. 172 (b) (2) (B) and subpar. (C)	−10,000
Total	8,685

[2] X's post-acquisition part year income of $0 is determined as follows:

Divided portion of income computed with modifications specified in sec. 172 (b) (2) (A)	$18,180
Net operating loss deduction made up of net operating loss carryovers (from prior years) of $6,000 (Y 1952), $10,000 (Y 1953), and $25,000 (Y 1954)	−41,000
Income is not considered less than zero	0

Y's 1954 net operating loss would be treated as follows:

Net operating loss	$25,000
Y's income for taxable year ended July 4, 1955, computed under sec. 172 (b) (2)	0
Net operating loss carryover to X 1955	25,000
X's post-acquisition part year income computed under sec. 172 (b) (2) and subpar. (C)	[1] −2,180
Net operating loss carryover to 1956	22,820

[1] X's post-acquisition part year income of $2,180 is determined as follows:

Divided portion of income computed with modifications specified in sec. 172 (b) (2) (A)	$18,180
Net operating loss deduction made up of net operating loss carryovers (from prior years) of $6,000 (Y 1952) and $10,000 (Y 1953)	−16,000
Total	2,180

Assuming X remained on the calendar year basis, the years to which the net operating losses may be a carryover under section 172 (b) (1) are:

Loss year	Carried to
Y 1952	Y 1953, Y 1954, Y July 4, 1955, X 1955, X 1956.
Y 1953	Y 1954, Y July 4, 1955, X 1955, X 1956, X 1957.
X 1953	X 1954, X 1955, X 1956, X 1957, X 1958.
Y 1954	Y July 4, 1955, X 1955, X 1956, X 1957, X 1958.
X 1954	X 1955, X 1956, X 1957, X 1958, X 1959.

Paragraph (2) of subsection (c) provides that in a liquidation to which section 332 applies (except in a case in which the basis of the assets distributed are determined under sec. 334 (b) (2)), or in transfer pursuant to a reorganization described in sec. 368 (a) (1) (A), (C), (D) (but only if the requirements of sec. 354 (b) (1) (A) and (B) are met, or (F), the earnings and profits (including a deficit in earnings and profits) of the distributor or transferor corporation shall become the earnings and profits of the acquiring corporation. Since it is required, except in the case of a transfer pursuant to a reorganization qualifying under section 368 (a) (1) (F), that, for the purposes of section 381, the taxable year of the distributor or transferor corporation end on the date of the distribution or transfer, the amount which becomes part of the earnings and profits of the acquiring corporation shall be the earnings and profits of the distributor or transferor corporation accumulated after February 28, 1913, and becomes part of the earnings and profits of the acquiring corporation accumulated after February 28, 1913. In no case shall the earnings and profits of the distributor or transferor corporation, whether or not earnings and profits of the taxable year which ends on the date of distribution or transfer, be considered a part of the earnings and profits for the first taxable year of the acquiring corporation which ends after the date of distribution or transfer. (See sec. 316 (a) relating to dividends.)

If the distributor or transferor corporation has a deficit in earnings and profits, section 381 (c) (1) (B) is intended to provide that such deficit may only be included in the earnings and profits of the acquiring corporation accumulated after the date of acquisition. That is, such deficit cannot be used to reduce earnings and profits of the acquiring corporation accumulated before the date of acquisition. Likewise, a deficit of the acquiring corporation can only be used to reduce earnings and profits of the acquiring corporation accumulated after the date of acquisition and cannot be used to reduce earnings and profits acquired from the distributor or transferor corporation. The amount of earnings and profits of the first taxable year of the acquiring corporation which ends after the date of acquisition which may be reduced by a deficit of a distributor or transferor corporation is that amount which bears the same ratio to the total undistributed earnings (earnings which, but for the operation of this section, would, at the end of the taxable year, be included in earnings and profits of the acquiring corporation accumulated after February 28, 1913) for such year as the number of days of such year after the date of acquisition bears to the total number of days in such year. The undistributed earnings for the year shall be determined without regard to such deficit. In the event that the acquiring corporation has earnings and profits accumulated after February 28, 1913, and such deficit exceeds the post-acquisition date undistributed earnings for such taxable year, the excess of such deficit over such earnings shall be used to reduce the undistributed earnings of the next succeeding year determined without regard to such excess, and, if necessary, in the following succeeding years. In no case may a succeeding year by omitted for the purpose of reducing undistributed profits in succeeding years. However, if the acquiring corporation had a deficit in earnings and profits accumulated after February 28, 1913, on the date of acquisition, such deficit of the distributor or transferor corporation shall be included in the deficit of the acquiring corporation on the date of acquisition.

It is intended that "earnings and profits" as used in this section shall have the same meaning as it has for the purposes of section 316 (a). See section 312 of this report for appropriate adjustments to earnings and profits.

Paragraph (3) of subsection (c) allows a corporation which acquires property in a transaction described in subsection (a) to deduct a short-term capital loss on account of any capital loss carryover which the distributor or transferor corporation would have been entitled to had it not transferred the property. The first year in which such loss may be deducted is the first taxable year of the acquiring corporation ending after the date of acquisition. However, the deduction in such year attributable to a capital loss carryover from a distributor or transferor corporation cannot exceed an amount determined under paragraph (3) (B). In determining the amount of the capital loss which is a carryover to a subsequent taxable year, that is, to a year following the first taxable year of the acquiring corporation ending after the date of distribution or transfer, it is necessary to reduce the capital loss carryover by the amount of any net capital gain against which it was deducted in such first taxable year of the acquiring corporation. Subject to the limitation in subparagraph (B), the capital loss which is a carryover to the fewest number of years subsequent to such first taxable year of the acquiring corporation should be deducted first against any capital gain in such taxable year.

For example, assume corporation X has a capital loss carryover from the calendar year 1953 of $10,000 and corporation Y has a capital loss carryover, also from the calendar year 1953, of $3,000. Y transfers all its property to X on September 30, 1954, in a transaction described in subsection (a) (2), closes its taxable year on that date and has no capital gains during said year. X has capital gains (computed without regard to a capital loss carryover) in 1954 of $10,000. Since Y's 1953 capital loss is first a capital loss carryover to Y's taxable year ending in 1954 and then to X's 1954 taxable year, it will be a carryover to one less year subsequent to 1954 than X's 1953 capital loss. Therefore, it should be applied against X's 1954 capital gains first, subject to the limitation in subparagraph B which provides that the capital loss carryover from Y is limited in X's 1954 taxable year to 92/365 of $10,000 or $2,520.80. Thus, $2,520.80 of Y's capital loss carryover will be applied against X's 1954 capital gain and the remainder of Y's capital loss carryover, $479.20 will be a capital loss carryover to 1955. X's capital loss carryover from 1953 will be applied against the remainder of X's 1954 capital gain, leaving a capital loss carryover to 1955 of $2,520.80.

Paragraph (4) of subsection (c), relating to method of accounting, requires that if the acquiring corporation and the distributor or transferor corporation (or corporations) used the same method of accounting before the date of acquisition, the acquiring corporation shall continue to use such method after the date of acquisition. If different methods are used before the acquisition date, the acquiring corporation shall use the method or combination of methods of accounting, pursuant to regulations prescribed by the Secretary or his delegate in connection with section 446 (relating to a general rule for methods of accounting).

Paragraph (5) of subsection (c) is intended to provide that, except for specific provisions in this subchapter with respect to the basis of inventory received by an acquiring corporation in a transaction described in subsection (a), such inventory shall be used by the acquiring corporation on the same basis on which such inventory was used by the distributor or transferor corporation in determining its taxable income unless a different basis is approved by the Secretary or his delegate in accordance with section 471 (relating to a general rule for inventories).

Paragraph (6) of subsection (c) provides that if the acquiring corporation acquires an asset with respect to which the distributor or transferor corporation computes a depreciation allowance under paragraphs (2), (3), or (4) of section 167 (b), the acquiring corporation must compute the depreciation allowance on such asset in the same way. However, the depreciation allowance under paragraphs (2), (3), or (4) of section 167 (b) is limited to the basis of such asset (for determining gain) in the hands of the acquiring corporation which does not exceed the basis of such asset in the hands of the distributor or transferor corporation.

Paragraph (7) of subsection (c) provides that if a distributor or transferor corporation had elected to report prepaid income in the manner described in section 452, the acquiring corporation after the acquisition shall be treated as if it were the distributor or transferor corporation provided the liability described in section 452 (e) (2) is assumed and the cash receipts and disbursements method of accounting is not used by the acquiring corporation. If the acquiring corporation uses the cash receipts and disbursements method of accounting, it shall include in its gross income for the first taxable year ending after the date of acquisition so much of the prepaid income as has not been included in the gross income of the distributor or transferor corporation.

Paragraph (8) of subsection (c) provides that the acquiring corporation shall report the income from any installment obligation which it acquires from a distributor or transferor corporation in a transaction described in subsection (a), pursuant to section 453, if such distributor or transferor corporation reported the income from such obligation on the installment basis before the transfer. In such a case it is intended that the acquiring corporation shall be treated as the distributor or transferor corporation would have been treated had it not transferred the obligation.

Paragraph (9) of subsection (c) provides that in cases where the acquiring corporation assumes the liability for bonds of a distributor or transferor corporation in a transaction described in subsection (a), the acquiring corporation shall be treated as the distributor or transferor corporation would have been had it not transferred the liability for the bonds, for the purpose of determining the amount of amortization allowable as a deduction or includible in income with respect to such discount or premium.

Paragraph (10) of subsection (c) is intended to provide that if the acquiring corporation acquires a mine or mineral deposit in a transaction described in subsection (a), and the distributor or transferor corporation had elected to deduct exploration and development expenses ratably out of the production of such mine or mineral deposit, pursuant to sections 615 or 616 (relating to exploration and development expenses, respectively), the acquiring corporation shall be entitled to deduct such expenses as if it were the distributor or transferor corporation and had not transferred such mine or mineral deposit. In applying the limitation with respect to exploration expenses provided in section 615 (c) to the acquiring corporation, the number of years in which such expenses were deducted currently, or were deferred by the distributor or transferor corporation, shall be included in the total of the years in which such expenses are deducted currently, or are deferred by the acquiring corporation, in spite of the fact that the particular property to which such exploration expenses relate may not have been transferred. If there are 2 distributor or transferor corporations, although each deducted such expenses currently in the taxable year ending on the date of distribution or transfer or elected to defer such expenses in such year, only 1 year shall be included in such total of the acquiring corporation.

Paragraph (11) of subsection (c) provides that for the purpose of determining the amounts deductible under section 404, relating to deductions for contributions of an employer to an employer's trust or annuity plan and compensation under a deferred-payment plan, the acquiring corporation shall be treated as if it were the distributor or transferor corporation and there had been no transaction described in subsection (a). It is intended that the acquiring corporation fulfill the requirements which were imposed upon the distributor or transferor corporation as a prerequisite to such deductions, before such deductions are allowed to the acquiring corporation.

Paragraph (12) of subsection (c) provides that if, in a transaction described in subsection (a), the distributor or transferor corporation transfers to the acquiring corporation the right to recover bad debts, prior taxes, and delinquency amounts previously deducted or credited by the distributor or transferor corporation, the acquiring corporation shall include in its income such amounts as would have been includible by the distributor or transferor corporation pursuant to section 111 (relating to recovery of bad debts, prior taxes, and delinquency amounts).

Paragraph (13) of subsection (c) provides that the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer for the purposes of applying section 1033 (relating to involuntary conversions) if the property or stock referred to in section 1033 (a) (2) and (3) is included in the property transferred in a transaction described in subsection (a).

Paragraph (14) of subsection (c) is intended to provide that for taxable years ending after the date of a transaction described in subsection (a), an acquiring corporation which is a personal holding company may include a dividend carryover (described in section 564) of a distributor or transferor corporation in the computation of the dividends paid deduction under section 561, to the same extent as the distributor or transferor corporation could have included such carryover if the transaction described in subsection (a) had not occurred.

Paragraph (15) of subsection (c) is intended to provide that in computing its undistributed personal holding company income under section 545, for taxable years ending after the date of a transaction described in subsection (a), an acquiring corporation, which is a personal holding company, may deduct, to the same extent as the distributor or transferor corporation could deduct amounts set aside to pay or retire certain indebtedness incurred prior to January 1, 1934.

Paragraph (16) of subsection (c) permits the acquiring corporation to deduct amounts which arise out of an obligation of the distributor or transferor corporation paid or accrued by the acquiring corporation after the date of distribution or transfer provided the obligation is assumed by the acquiring corporation, provided also that the obligation gives rise to a liability after the date of distribution or transfer and such liability if paid or accrued by the distributor or transferor corporation after such date would have been deductible in computing its taxable income, and provided the obligation was not reflected in the amount of consideration transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation. In other words, if the amount of stock, securities, and property of the acquiring corporation transferred in exchange for the property of the transferor corporation was determined by including the obligation as a liability in valuing the property of the transferor corporation, the subsequent payment of such obligation will not be deductible by the acquiring corporation under paragraph (16). This paragraph is not intended to permit the acquiring corporation to deduct amounts paid on account of a liability of the distributor or transferor corporation which accrued or was accruable by the distributor or transferor corporation prior to the date of distribution or transfer.

Paragraph (16) of subsection (c) also permits the deduction in taxable years beginning after December 31, 1953, of amounts paid for obligations described in the preceding paragraph even though the date of distribution or transfer occurred prior to the effective date of the provisions of this code applicable to the liquidations and reorganizations described in subsection (a). For example, if Y corporation transferred all its property to X corporation in 1942 in a transaction which, if it had occurred after the effective date of part III, would have been a transaction described in subsection (a) (2), and X corporation assumed an obligation of Y corporation to make monthly pension payments directly to Y corporation's retired employees for as long as each should live, but such obligation was not taken into account in determining the amount of stock, securities, or property transferred by X to Y in exchange for Y's property, then X corporation can deduct in taxable years beginning after December 31, 1953, the payments made in each such year to Y's retired employees.

Paragraph (17) entitles an acquiring corporation to a deficiency dividend deduction paid with respect to the distributor or transferor corporation. In the House bill, a similar provision was placed in section 547. Your committee has stricken the provision from section 547 and added it as a carryover item to section 381.

Paragraph (18) permits an acquiring corporation to claim percentage depletion on so-called mine tailings distributed or transferred to it by the distributor or transferor corporation just as if it were the distributor or transferor corporation. This provision has no counterpart in the House bill.

Section 382. Special limitations on net operating loss carryovers

Your committee has retained this section of the House bill but has made some changes and additions. The section in the House bill provided generally that if 50 percent or more of a corporation's stock changed hands during a 2-year period as the result of a purchase or redemption of stock, the net operating loss carryovers of such corporation would be reduced by the percentage of the change of ownership. The section now provides, generally, that if 50 percent or more of a corporation's stock changes ownership during a 2-year period as the result of a purchase or redemption of stock, and if the corporation changes its trade or business, then any net operating loss carryovers will be entirely eliminated. In addition, the section contains a new limitation on net operating loss carryovers in those corporate reorganizations described in section 381. This provision reduces the net operating loss carryovers of either the transferor or acquiring corporation unless there is a 20 percent or more continuity of interest in the resulting corporation retained by the stockholders of the corporation with the net operating loss carryovers.

If a limitation in this section applies to a net operating loss carryover, section 269, relating to acquisitions made to evade or avoid income tax, shall not also be applied to such net operating loss carryover. However, the fact that a limitation under this section does not apply shall have no effect upon whether section 269 applies.

Subsection (a) applies to the purchase of a corporation and change in its trade or business. It is applicable to any corporation which falls within each of the three conditions specified in subparagraphs (A), (B), and (C) of paragraph (1). Subparagraph (A) provides that 1 or more of the 10 largest unrelated stockholders must own, at the end of the taxable year, a percentage of the fair market value of the outstanding stock which is at least 50 percentage points more than such person or persons owned at either the beginning of such taxable year or the prior taxable year. Thus, subsection (a) will not be applicable unless the 10 largest stockholders own at least 50 percent of the fair market value of the oustanding stock and, then, will only be applicable if 1 or more of such 10 persons has increased the percentage of the fair market value of the outstanding stock he or they own by 50 percentage points or more during the specified period. An increase of 50 percentage points does not mean the same as a 50-percent increase. Thus, a stockholder who owns 4 percent of the fair market value of the outstanding stock and who increases his ownership to 6 percent has had a 50-percent increase in ownership but only a 2 percentage point increase. Paragraph (3) of subsection (a) gives the rules for determining ownership of stock and paragraph (2) specifies the persons to be used in determining whether the conditions in subparagraph (A) have been met. Subparagraph (B) provides that the increase of 50 percentage points required in subparagraph (A) must be caused by a purchase by the person who has the increase or by a decrease in the amount of outstanding stock (but not a decrease resulting from redemption to pay death taxes to which sec. 303 applies). The subparagraph is worded so as to prevent avoidance of the limitation through the purchase of an interest in a corporation, partnership, or trust owning stock in the corporation with the net operating loss carryover. An increase in percentage of stock owned resulting from a purchase by some other person, a tax-free reorganization, a gift, or a devise is not counted in determining whether the 50 percentage point increase has been reached. Subparagraph (C) contains the third condition which must be met before the limitation in subsection (a) is applicable. It provides that if the corporation has not continued to carry on a trade or business substantially the same as that conducted immediately before any change in the percentage ownership of the fair market value of the stock, the condition in subparagraph (C) is met. The change in percentage ownership refers to an increase which would be counted under subparagraphs (A) and (B) in determining whether the 50 percentage point increase has been reached. If, as a result of such an increase, the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business as was conducted before such an increase, then the condition in subparagraph (C) is met.

Paragraph (2) of subsection (a) specifies the 10 persons (more or less) who are used to determine whether there has been a 50 percentage point increase in the ownership of the fair market value of the outstanding stock. The attribution rules specified in paragraph (3) are applicable in determining the ownership of stock. It is provided, however, that persons so related to each other that the stock of one is attributed to the other shall be considered as only 1 person solely for the purpose of selecting the 10 persons (more or less) who own the greatest percentage of the fair market value of the stock. For example, assume A, the largest stockholder of X corporation, owns 60 percent of the fair market value of the outstanding stock and has 9 living children. Under the attribution rules, each of the 9 children will be considered to own 60 percent also. However, in selecting the 10 persons described in paragraph (2), A and his children will be considered only 1 person and it will be necessary to select at least 9 more persons owning the next largest percentage of stock or such lesser number as there are persons owning the remaining stock. Even though, for purposes of paragraph (2), related persons are considered as only one person, in applying the conditions in paragraph (1), each person is to be considered separately.

Paragraph (3) specifies the attribution of ownership rules which are to be applied in determining the ownership of stock for purposes of subsection (a).

Subsection (b) is designed to prevent the liberalized carryover of net operating losses permitted in section 381 from being used by one corporation to acquire the total net operating loss carryovers of another corporation without giving up at least a 20 percent share to the stockholders of the corporation with the net operating loss carryover. If the stockholders of the loss corporation have a 20 percent or more interest in the successor corporation, it is felt there is a sufficient continuity of interest in the net operating loss carryover to justify permitting the entire net operating loss to carry over. If, however, the stockholders of the loss corporation receive less than a 20 percent interest in the successor corporation, the net operating loss carryover is reduced as provided in paragraph (2). The 20 percent continuity of interest requirement is intended to apply to the corporation which includes the net operating loss carryover in its net operating loss deduction. Thus, the 20 percent requirement cannot be watered down by inserting one or more corporate entities between the corporation with the loss and the corporation deducting the loss.

Paragraph (1) sets out the general rule which is applicable only in the case of a reorganization specified in paragraph (2) of section 381 (a). In such a case, it is applicable regardless of whether the transferor corporation, the acquiring corporation, or both, have a net operating loss carryover. The stockholders of the corporation with the net operating loss carryover must own, as a result of owning stock in the loss corporation immediately before the reorganization, 20 percent or more of the fair market value of the outstanding stock of the acquiring corporation or the reduction in paragraph (2) will apply. For example, assume X corporation has a net operating loss carryover to 1955 of $100,000 and assets valued at approximately 4 percent of the value of the assets of Y corporation. Y merges into X in a statutory merger on December 31, 1954. Y's stockholders own, as a result of the reorganization, 96 percent of the fair market value of X's outstanding stock and X's stockholders now own 4 percent of such fair market value. In such a case, the limitation would be applicable to the net operating loss carryover to 1955 because the stockholders of the loss corporation owned only a 4 percent interest in the successor corporation. Assume the above example and the additional fact that on December 30, 1954, X's stockholders purchased one-third of Y's stock from its stockholders. After the reorganization, X's stockholders before the reorganization would own 4 percent of X's stock as a result of owning stock of the loss corporation and 32 percent (one-third of 96 percent) of X's stock as a result of owning stock in X corporation. Hence, the limitation would also apply.

The reduction of the net operating loss carryover is determined in paragraph (2). In the above examples, the stockholders of the loss corporation owned 4 percent of the fair market value of the outstanding stock of the acquiring corporation as the result of owning stock of the loss corporation. Under paragraph (2), the 4 percent would be multiplied by 5 to give 20 percent and this amount would be subtracted from 100 percent to give the percentage of reduction, 80 percent.

Paragraph (3) provides that the limitation in subsection (b) shall not apply if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportions.

Paragraph (4) provides for the appropriate reduction in a net operating loss carryover not completely absorbed in the year in which the limitation in this subsection is applicable. The effect of this paragraph is to apply the reduction against the oldest net operating loss first, and then, if necessary, against subsequent net operating losses in order.

Subsection (c) gives the definition of stock. It is applicable to both subsections (a) and (b).

PART VI—EFFECTIVE DATE OF SUBCHAPTER C

This part provides rules with respect to the time when the various other parts of this subchapter shall take effect. Your committee has revised the effective dates of these provisions in an attempt to remove any hardship which may result to a taxpayer by reason of an unanticipated change in the tax law where the taxpayer may be in the process of completing a transaction in reliance on such law as it now exists.

Section 391. Effective date of part I

This section provides that part I of this subchapter, relating to distributions by corporations, shall take effect on June 18, 1954, unless otherwise provided. Section 306, relating to the disposition of certain stock, applies only with respect to dispositions (or redemptions) occurring on or after June 18, 1954. Since, in general, section 306 (h) exempts from the application of the section stock which is outstanding prior to June 18, 1954, section 306 will be only prospective in its application.

Section 392. Effective date of part II

Except as otherwise provided in this subchapter, part II, relating to corporate liquidations, shall apply to liquidations only if the first distribution in pursuance of the plan of liquidation occurs on or after June 18, 1954. Section 341, relating to collapsible corporations, applies regardless of whether the corporation makes distributions in liquidation and accordingly, this section is made applicable with respect to sales, exchanges, and distributions on or after June 18, 1954.

Section 393. Effective dates of parts III and IV

Subsection (a) of this section provides that except as otherwise provided in this subchapter, parts III and IV, relating to corporate reorganizations and insolvency reorganizations, respectively, shall take effect on June 18, 1954.

Subsection (b) provides special rules involving the adoption of plans of reorganization. One example of the adoption of a plan of reorganization is a resolution by the board of directors of a corporation, or by its shareholders, whether or not such resolution would constitute sufficient authorization under the applicable stated law. In the event that it is desired to have the rules of the 1954 Code apply, your committee does not intend to prohibit the readoption of an existing plan of reorganization.

Paragraph (1) states the general rule that parts III and IV apply only in respect of plans of reorganization adopted on or after June 18, 1954, and for this purpose a plan to make an exchange or distribution which is described in section 355 (or so much of sec. 356 as relates to sec. 355) shall be treated as a plan of reorganization.

Paragraph (2) provides a special rule applicable to cases where a plan of reorganization was submitted to the Secretary for ruling prior to June 18, 1954, and where the plan of reorganization was not, however, adopted before that date. In such a case the corporations which are parties to the reorganization may elect, under regulations, to complete the reorganization in accordance with the plan so submitted in the event a ruling is issued with respect to such plan, regardless of the date of its issuance. If the election is made under this paragraph the tax treatment, both as to corporations which are parties to the reorganization and to their shareholders and security holders, shall be determined under the Internal Revenue Code of 1939 in accordance with the contents of such ruling. Your committee does not intend that a corporation which is not in existence on June 18, 1954, shall be required to make the election prescribed herein. In such a case it will be sufficient if the corporations still in existence make the required election.

Paragraph (3) allows an election in certain cases to have the rules of the 1954 Code apply to a plan of reorganization which has been adopted prior to the June effective date of parts III and IV. If a plan of reorganization was adopted after March 1, 1954, and before June 18, 1954, or was adopted before June 18, 1954, in pursuance of a court order and all distributions under the plan occur after March 1, 1954, and before July 1, 1954, this election is available. The election is to be made, under regulations, by the corporations which are parties to the reorganization. In such event the tax treatment of the reorganization at both the corporation and shareholder levels shall be determined under the Internal Revenue Code of 1954. In the event that the plan contemplates an exchange or distribution described in section 355 and related provisions, which would not constitute a reorganization under the 1939 Code, then the plan to make an exchange or distribution shall be treated as a plan of reorganization for purposes of this paragraph.

Section 394. Effective date of part V

This section establishes the effective dates for applying sections 381 and 382.

Subsection (a) of this section provides that section 381, relating to carryovers in certain corporate acquisitions, shall apply to liquidations and reorganizations, the tax treatment of which is determined under the Internal Revenue Code of 1954. Thus, under the general rule with respect to reorganizations, section 381 will apply in the case of plans of reorganization adopted on or after June —, 1954, and will not apply in the case of an election to have the Internal Revenue Code of 1939 applicable to a reorganization under section 393 (b) (2).

Subsection (b) provides the effective date for section 382 (a), relating to special limitations on net operating loss carryovers as a result of a change in ownership. For purposes of applying the special limitation in section 382 (a), the beginning of the taxable year specified in clauses (i) and (ii) of section 382 (a) (1) (A) shall be considered to be the beginning of such taxable year or June —, 1954, whichever occurs later.

Subsection (c) supplies the effective date for the application of section 382 (b), relating to limitations on loss carryovers where a change of ownership is the result of a reorganization. Section 382 shall apply to reorganizations, the tax treatment of which is determined under the Internal Revenue Code of 1954.

Section 395. Special rules for application of this part

This section provides rules intended to supplement the rules previously described in this part. Subsection (a) provides that any provision of this subchapter, the applicability of which is stated in terms of a specific date, shall apply with respect to taxable years ending after such date. In the case of a taxable year subject to the

1939 Code each provision of the 1954 Code shall be deemed to be included in the 1939 Code, but shall apply only to taxable years ending after such specific date.

Subsection (b) provides that to the extent the provisions of this subchapter supersede the provisions of the 1939 Code, the provisions of such code are repealed. The provisions of the 1939 Code shall continue to apply with respect to transactions for which rules are provided in subchapter C until such rules take effect.

SUBCHAPTER D—DEFERRED COMPENSATION, ETC.

PART I. PENSION, PROFIT-SHARING, AND STOCK-BONUS PLANS

Part I of subchapter D, which includes sections 401 through 404, continues, with the exceptions described below, the provisions of the 1939 Code relating to qualification of stock bonus, pension, and profit-sharing plans; taxability of distributions from employees' trusts; taxability of employee annuities; and deductions for contributions of an employer to an employees' trust or annuity plan.

Section 401. Qualified pension, profit-sharing, and stock-bonus plans

This section corresponds to section 165 (a) of the 1939 Code, and section 162 (d) (2) (B) of the Revenue Act of 1942, as amended by Public Law 511 (78th Cong.), approved December 20, 1944, relating to qualification of employees' trusts. Present law is changed only by providing, as in the House bill, that a trust may qualify only if it is a trust created or organized in the United States.

Section 402. Taxability of beneficiary of employees' trust

This section corresponds to section 165 (b), (c), and (d) of the 1939 Code, relating to taxability of beneficiaries of employees' trusts. Section 165 (b) of the 1939 Code provides that if the total distributions payable by a qualified employees' trust are paid to the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service of the employer, the amount of such distribution to the extent exceeding the amounts contributed by the employee shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. This capital gains treatment of existing law is continued in section 402 (a) (2) and, like the House bill, is extended to cases where the distribution is on account of the death of the employee after his separation from the service. In addition, like the House bill, capital gains treatment is provided in certain cases by section 402 (e) where distributions are made on termination of a plan if such termination is incident to the complete liquidation of the corporate employer. However, the House bill has been restricted so that this provision will apply only in the case of distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of a stock bonus, pension, or profit-sharing plan of an employer which is a corporation, if the termination of the plan is incident to the complete liquidation, occurring in a year prior to the calendar year in which any such distributions are made, of the corporation, whether or not such liquidation is incident to a reorganization as defined in section 368 (a). The disappearance of the corporate entity by reason of the merger or consolidation of such corporation with another corporation will constitute a liquidation for purposes of this provision. For purposes of section 402 (a) (2), the term "total distributions payable" is defined as the balance to the credit of an employee which becomes payable to a distributee by reason of occurrence of the specified events, so that partial distributions made prior to occurrence of the specified events will not defeat application of the capital gains treatment.

Except in the cases where capital gains treatment is provided, distributions by employees' trusts will, as under present law, be taxable as annuities. The rules set forth in section 72, relating to taxation of annuities, will apply except that, like the House bill, the 3-year averaging device provided by section 72 (e) (3) for certain amounts not received as annuities would not be applicable to distributions within the scope of section 402.

The rules of section 165 (b) of the 1939 Code, regarding the tax treatment of unrealized appreciation in the securities of the employer corporation where there is a distribution of such securities, are retained unchanged in section 402 (a) (1) and (2). In addition the term "securities of the employer corporation" would continue to be defined as including securities of a parent or subsidiary corporation (as defined in section 421 (d) (2) and (3)) of the employer corporation. This definition thus incorporates the liberalizing change in the section 421 definition of parent or subsidiary corporation under which, for example, an employer corporation would be the parent of another corporation of which it owns 50 percent or more of the total combined voting power of all classes of stock. Under existing law such employer corporation would be the parent only if it owned more than 50 percent of such stock.

A further change made in the House bill relates to the taxability of beneficiaries of certain foreign situs trusts. A stock bonus, pension, or profit-sharing trust created or organized outside the United States may not be exempt from tax under section 501 (a) since a specific requirement for qualification under section 401 (a) is that the trust be created or organized in the United States. However, section 402 (c), added to the House bill, provides that for purposes of section 402 (a) and (b), relating to taxability of beneficiaries of employees' trusts, a stock bonus, pension, or profit-sharing trust, which would qualify for exemption from tax under section 501 (a) except for the fact that it is a trust created or organized outside the United States, shall be treated as if it were a trust exempt from tax under section 501 (a).

Section 403. Taxation of employee annuities

This section corresponds to section 22 (b) (2) (B) of the 1939 Code, relating to taxability of employees' annuities. Existing law provides that if the total distributions payable by a qualified employees' trust are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from the service of the employer, the amount of such distribution to the extent exceeding the amounts contributed by the employee shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. As in the House bill, similar capital gains treatment is provided by this section for lump-sum distributions in connection with employee annuities, and also for such distributions made by reason of the death of an employee after his separation from the service of the employer. Specifically, section 403 (a) (2) provides that if an annuity contract is purchased by an employer for an employee under a plan which meets the nondiscrimination requirements for qualified trusteed plans, if the plan requires that refunds of contributions with respect to annuity contracts purchased under the plan be used to reduce subsequent premiums on the contracts under the plan, and if the total amounts payable by reason of an employee's death or other separation from service, or by reason of the employee's death after separation from service, are paid to the payee within 1 taxable year of the payee, then the gain on receipt of such payments shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

The term "total amounts" is defined as the balance to the credit of an employee which becomes payable to the payee by reason of occurrence of the specified events, so that partial distributions made prior to occurrence of the specified events will not defeat application of the capital-gains treatment.

In those cases where capital-gains treatment does not apply, employee annuities will, of course, be taxable under section 72, relating to the taxation of annuities, except that, like the House bill, the 3-year averaging device provided by section 72 (e) (3) for certain amounts not received as annuities would not be applicable to employee annuities within the scope of section 403.

Section 404. Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan

This section corresponds to section 23 (p) of the 1939 Code, relating to employer deductions for contributions to employees' trusts and annuity plans.

Profit-sharing plan of affiliated group (sec. 404 (a) (3) (B)).—This provision, which was also in the House bill, relates to the shifting under certain circumstances of contributions, and deductions for such contributions, among members of an affiliated group of corporations which has a common profit-sharing plan and, in certain cases, a common stock bonus plan. Under existing law a group of corporations may establish a common profit-sharing plan, but there may be no shifting of contributions or deductions among the group. For example, if one member of the group has a loss in a given year, and no accumulated earnings or profits, it could not make a contribution to the plan for its employees, and no other member of the group could make the contribution on its behalf. Under section 404 (a) (3) (B) if a profit-sharing plan, or a stock bonus plan in which contributions are determined with reference to profits, is established by a group of corporations which is an affiliated group, as that term is defined for purposes of filing consolidated returns, and a member of the group is prevented from making a contribution because it has no current or accumulated earnings or profits, the contribution could be made for the benefit of the employees of the loss corporation, by the members of the group that have profits. Under the amendment, if the group does not file a consolidated return, the members of the group would be required to divide up the contribution so that each would make up that proportion of the contribution for the loss member which its profits bear to the total profits of the members which have profits.

Each member of the group making a contribution under these rules on behalf of a loss member would be allowed to deduct the contribution. However, in determining any credit carryover of such loss member, contributions made by other members of the group on behalf of the loss member would be treated as if made by the loss member. The provision is identical to the House bill except that it has been extended to stock bonus plans in which contributions are determined with reference to profits, and allocation of the contribution among the profit members would not be required where a consolidated return is filed.

Trusts created or organized outside the United States (sec. 404 (a) (4)).—A stock bonus, pension, or profit-sharing trust created or organized outside the United States may not be exempt from tax under section 501 (a) since a specific requirement for qualification under section 401 (a) is that the trust be created or organized in the United States. However, section 404 (a) (4) specifically provides, like the House bill, that if a stock bonus, pension, or profit-sharing trust would qualify for exemption under section 501 (a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible under the preceding paragraphs of section 404 (a).

Taxpayers on accrual basis (sec. 403 (a) (6)).—Section 404 (a) (6) provides, like the House bill, that for purposes of paragraphs (1), (2), or (3) of section 404 (a) an accrual-basis taxpayer shall be deemed to have made a payment under a plan on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). This provision is like section 23 (p) (1) (E) of the 1939 Code except that the present law grants a period of only 60 days after the close of the taxable year in which such payment must be made in order to be deemed made in the year of accrual.

Certain negotiated plans (sec. 404 (c)).—This provision, which is not in the House bill, provides that if contributions are paid by an employer under a plan under which such contributions are held in a welfare trust for the purpose of paying for the benefit of employees and their families and dependents at least medical or hospital care and pensions on retirement or death of employees, and such plan is established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation under seizure powers of a major part of the productive facilities of the industry in which such employer is engaged, such contributions shall be deductible under section 162 (relating to trade or business expenses). The enactment of this provision is not intended to have any effect on the interpretation of the 1939 Code.

The expression in the bill "as a result of an agreement" is intended primarily to cover a trust established under the terms of such an agreement. It will also include a trust established under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity.

If any such trust becomes qualified for exemption under section 501 (a), the deductibility of contributions by an employer to such trust on or after the date of such qualification would no longer be governed by this provision, even though the trust may later lose its exemption under section 501 (a).

Carryover of unused deductions (404 (d)).—This provision, which was contained in the House bill, preserves for employers a carryover of unused deductions and contributions in excess of deductible amounts for taxable years to which part I of subchapter D does not apply and which would have been deductible in later years if section 23 (p) of the 1939 Code, providing for such carryovers, were continued in effect in taxable years to which part I of subchapter D applies. However, the House bill has been changed by adding a sentence which will insure that duplicate deductions cannot be claimed in any taxable year to which part I of subchapter D applies under the new code and under section 23 (p) of the 1939 Code. The following example will illustrate the application of the added sentence. Assume that an employer filing returns on the calendar year basis makes a $500,000 contribution to a pension trust in 1953 and a $500,000 contribution in 1954 on account of past service liability. Assume further that the past service liability is $1 million. The employer may not claim a deduction in 1954 of $100,000 (10 percent of past service liability) under section 23 (p) and a duplicate deduction of $100,000 for the same year under section 404 (a) (1) (D). His deduction will be limited to $100,000.

Part II—Miscellaneous Provisions

Section 421. Employee stock options

This section, which corresponds to section 421 of the House Bill, revises section 130A which was added to the 1939 Code by the Revenue Act of 1950 to provide special rules for the tax treatment of certain employee stock options. The statutory scheme of section 130A has been substantially retained but certain changes have been made to eliminate ambiguities and to provide more definite rules with respect to unanswered problems raised by the enactment of section 130A.

The first change is to provide specifically that variable price options are entitled to the benefits of this section. A variable price option is an option in which the price to be paid by the employee for stock under the option is not determinable at the time the option is granted because it is computed under a formula that is related to the market value of the stock at a date subsequent to the granting of the option. The variable price option was not easily adaptable to the statutory language of section 130A, since that section, as drafted, appeared applicable only where the price to be paid for the stock under the option was the same at the time the option was granted as at the time the option was exercised.

This section now includes variable price options specifically by (1) permitting them to qualify under the percentage tests notwithstanding the fact that they may not be presently exercisable (clause (ii) of subsec. (d) (1) (A)); (2) limiting the compensation, in the case of 85 to 95 percent options, to the spread existing at the time the option was granted (subsec. (b) (2)); and (3) changing the amount received by the employer corporation to "price paid under the option" in lieu of "option price" as it was under section 130A (subsec. (a) (3)). For example, an option is given to X in connection with his employment entitling him to purchase, after the elapse of 1 year, 100 shares of the stock of A company, his employer, at 85 percent of market value. The market value of A company stock at the time the option is granted is $100 per share. One year later the market value of A company stock is $200 and X exercises the option buying 100 shares at $170 per share for a total of $17,000. After holding the stock for 2 years he sells the stock for $250 per share or $25,000. Since the purchase price of the stock under the option would have been $85 per share had the option been exercised at the date of grant, the option qualifies under clause (ii) of subsection (d) (1) (A). His gain under subsection (b) shall be the lesser of (1) $250 (market value when sold) minus $170 (price paid for stock); or (2) $100 (market value at the time the option was granted) minus $85 (the price that would have been paid for the stock had it been exercised at the date the option was granted). Consequently, X upon the sale of his 100 shares of A company stock will be taxable on $15 per share ($1,500) ordinary income and $65 per share ($6,500) capital gain. In determining the capital gain, the amount taxable as ordinary income ($15) is added to the purchase price of the stock ($170).

Your committee has modified this change by qualifying only those variable price options in which the price to be paid is computed under a formula having as its only variable the value of the stock purchased.

The second change is intended to preserve the benefits of this section for an employee having a restricted stock option where there is a corporate reorganization of the employer, or parent or subsidiary, or a change in ownership of any such corporations. Under section 130A (a) an employee must be an employee of either the corporation granting the option or a parent or subsidiary thereof at the time the option is exercised. A strict interpretation of this language would deny an employee the benefits of section 130A, for example, in the case where he was not employed by the corporation which had granted him the option but by a corporation which acquired his employer in a merger under State law. Since many restricted stock options give employees equivalent rights to purchase the stock of their new employer, this situation is not uncommon. Your committee intends to overcome this strict interpretation by providing in subsection (a) that the employment requirement is satisfied if the employee is employed by a corporation, or its parent or subsidiary, which has issued or assumed an option under subsection (g).

This change is also related to what constitutes a modification under subsection (e). When the new employer corporation, or its parent or subsidiary, or a new parent corporation assumes the option or issues a new option in place of it, does this constitute a modification? Subsection (e) has been amended by your committee to provide that the issuance or assumption of an option in accordance with the provisions of subsection (g) shall not constitute a modification.

Subsection (g) is intended to permit the assumption of the old option or the substitution of a new option in its place whenever this is necessary in order to preserve the rights of the employee under his old option by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization or liquidation. This subsection is not intended to apply to corporate transactions which do not affect the rights of the employee under his option. Furthermore, the aggregate spread between the option price and the value of all stock subject to the option immediately after the assumption or substitution must not be greater than such spread in the old option immediately before the assumption or substitution. The assumption or substitution also must not result in the employee obtaining additional benefits under the new option which he did not have in the old option. The only changes in the terms of the option which may be made are those made solely by reason of any of the corporate transactions described above and all terms of the old option must be maintained except to the extent such terms are rendered nugatory by reason of such transaction.

To illustrate the effect of subsection (g), suppose that E is employed by X corporation and has an option for 1,000 shares of its stock. Y, parent corporation of X, liquidates X. Under this section it is permissible for Y corporation to issue another option in place of the old option as long as the aggregate spread of the new option is not greater than the aggregate spread of the unexercised portion of the old option. Y corporation may grant an option for more than 1,000 shares but the spread for each share must be accordingly smaller in order that the aggregate spread in the new option does not exceed that of the old option. For example, if the spread in E's option from X corporation was $20 per share and Y should issue E an option for 2,000 shares, the spread must be $10 or less per share. The option from Y must not give E any additional benefits which he did not have under his option with X. For example, the privilege to purchase the stock subject to the option in installments and any exercise period longer than that in the old option would be considered additional benefits.

Your committee contemplates that subsection (g) will be applicable to corporate transactions such as a change in the parent-subsidiary status where the employee had an option in the parent, the disappearance of the corporate entity of the employer corporation or its parent or subsidiary, or the formation of a new employer corporation or parent or subsidiary of such corporation.

Another change is found in subsection (d) (1) (C) and provides that where the option price is at least 110 percent of the market value of the stock at the time the option is granted and the option is exercisable over a period of not more than 5 years, an employee may own more than 10 percent of his employer's stock at the time the option is granted and still be entitled to the benefits of this section. A minor change was made by your committee in this provision so that options may qualify under the exception if they are exercisable within 5 years or exercised within a year after the enactment of this title.

The next change is found in subsection (d) (1) (D) providing that restricted stock options granted after June 18, 1954, must be exercisable within a period of 10 years. This rule is intended to eliminate cases where options are granted covering a period of such great duration that the employee is almost certain of benefit, even though there is no action on his part to increase the success of the employer corporation. This provision has been retained by your committee, but the effective date has been changed to June 18, 1954.

Your committee has amended section 421 (d) (2) and (3) to alter the definition of parent and subsidiary. The present law requires ownership of stock possessing more than 50 percent of the voting rights, but your committee has provided that ownership of just 50 percent is sufficient.

Subsection (d) (4) (B) is changed and additionally defines a disposition as an event which terminates a joint tenancy except where the stock is reacquired by the employee and excludes from such definition the acquisition or transfer of stock acquired under a restricted stock option in joint tenancy. This provision is intended generally to incorporate the rule of section 39.130A-5 (3) (ii) of Regulations 118 in order that stock acquired in common-law States under a restricted stock option may be owned jointly without disadvantageous tax results.

Subsection (d) (6) has been amended to provide definite rules for the exercise of restricted stock options after the death of the employee. Under section 130A the tax consequences of the exercise of a restricted stock option by the estate or beneficiary of a deceased employee are in an uncertain state. This paragraph provides that the estate or beneficiary shall receive the same treatment the employee would have received had he lived and exercised the option. However, the estate or beneficiary is not required to be an employee at the time the option is exercised nor are they subject to the holding period requirements providing that the stock must not be sold prior to 2 years from the date the option was granted nor 6 months from the date the stock was acquired. In the year that an amount is includible, under subsection (b), in the income of the decedent's estate or beneficiary there shall be allowed a deduction for the estate tax attributable to the inclusion of the net value of the restricted stock option in the decedent's estate.

Your committee has amended this provision so that when the estate transferred the stock acquired by the exercise of the option to any beneficiary of the estate, such transfer would be treated as a disposition resulting in the inclusion of an amount in income where subsection (b) is applicable.

Subsection (e), relating to the modification, extension, or renewal of an option, has been revised. In the House bill, paragraph (1) applies to options granted prior to January 1, 1954, and exercisable over a period of more than 10 years and retains the present law of section 130A (e). Paragraph (2) applies to options exercisable over a period of not more than 10 years (this includes restricted stock options granted after December 31, 1953, and options granted at any time that are exercisable over a period of 10 years or less). This paragraph eliminates the requirement in present law that upon a modification, extension, or renewal the new option price must be at least 85 percent of the fair market value of the stock at its highest point on the date of grant or at the time of any subsequent modification, extension, or renewal. This worked a hardship in the case of options on stock that had declined in value, since situations developed where the option price after a modification, extension, or renewal had to be higher than the market value of the stock in order to qualify as restricted stock options. Additionally, a modification has been defined as any change in the terms of the option which gives the employee additional benefits under the option. For example, the shortening of the exercise period of an option would not be considered a modification. Also, any option granted after February 26, 1945, which would otherwise qualify as a restricted stock option except for the fact that it is assignable, may qualify as a restricted stock option by changing its terms to make it nonassignable and exercisable over a period of not more than 10 years from the date the option was granted without these changes being considered a modification of the option.

In general, your committee has retained the effect of the House revision of subsection (e). However, your committee has limited the exception to take care of a modification where the value of the stock has declined to situations in which the decline is relatively prolonged. Accordingly, the distinction between options granted before and after the enactment of this title is eliminated, and in all cases the highest value test is used unless there has been a 20-percent decline in the value of the stock over a 12-month period. The change to take care of corporate reorganizations has been retained by your committee by providing that the issuance or assumption of an option under subsection (g) shall not be treated as a modification. Furthermore, your committee expects that the rule of present law will be continued that a change in the option to reflect the distribution of stock dividends will not be treated as a modification. Your committee also continues the provision that a change making an option nonassignable will not be treated as a modification but only if at the same time the option is exercisable over a period of 10 years or less from the date it was granted.

The final change is found in subsection (f) and is intended to facilitate the administration of this section by making any necessary corrections in the year in which a premature disposition of stock acquired under a restricted stock option is made. Presently, when stock acquired under a restricted stock option is disposed of prior to 2 years from the date the option was granted or 6 months from the date the stock was acquired, the special treatment applicable to restricted stock options is lost. In these cases it has been necessary to open returns of the prior year of exercise in order to tax the employee and to allow the employer a deduction whenever permitted by law. This section is intended to make these adjustments more current.

SUBCHAPTER E—ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

PART I—ACCOUNTING PERIODS

Section 441. Period for computation of taxable income

This section corresponds to section 441 of the House bill.

Subsections (a), (c), and (g) adopt the rules and definitions contained in the first part of the first and in the second sentence of section 41 of the 1939 Code. Subsections (b), (d), and (e) are derived from section 48 (a) and (b) of the 1939 Code with the addition of the 52–53 week fiscal year.

Subsection (f) under the House bill permits a corporate taxpayer to elect a 52–53 week fiscal year. Your committee has amended this provision so that it would apply to all taxpayers who qualify therefor. In addition the provision is made effective for taxable years ending after the date of enactment of this title. Any taxpayer who regularly computes his income on the basis of a period which is either 52 or 53 weeks always ending on the same day of the week which either (1) occurs for the last time in a calendar month, or (2) falls nearest the end of a calendar month, may compute his income for tax purposes on the basis of that period. Under (1) the year may end as many as 6 days before the end of a month but must end within that month. Under (2) the year may end as many as 3 days before the end of a month or as many as 3 days after the end of a month. Under the 52–53 week fiscal year a taxpayer shall on the average have five 52-week fiscal years to each 53-week fiscal year.

Whenever it is necessary to determine when a taxable year begins, as for example, in case a new rate of tax applies to taxable years beginning after December 31, a 52-week year beginning on December 26, 27, 28, 29, 30, or 31 shall be treated as beginning on the 1st day of January—the first day of the month beginning nearest to the first day of the taxable year. Similarly, if a return must be made on or before the 15th day of the 3d month following the close of the fiscal year, a 52-week year ending on June 1, 2, or 3 shall be treated as ending on the preceding May 31, the last day of the month ending nearest to the last day of the taxable year. On the other hand, if the rate of tax changes during a 52- or 53-week taxable year, the special rules in paragraph (2) will not apply to the computation under section 21 (relating to changes in rates during a taxable year). For example, if a rate of tax for taxable years beginning after June 30, 1955, is reduced from 30 to 25 percent and a 52-week taxable year ends on August 27, 1955, the tax shall be computed under section 21 on the basis of the actual number of days in the taxable year before the effective date of the change of rate and the actual number of days in the taxable year on and after the change of rate. The tax shall be the same part of the tax computed on the annual basis as the number of days in the short period is of 365 days.

When a taxpayer changes to a 52–53-week taxable year, in most cases, there will be a short taxable year involved in the transition. If the taxpayer is merely changing from the end of a month to the particular day with reference to the end of the same month, the income for the short period will not be annualized. A short taxable year which is in excess of 358 days will be treated as a full taxable year, and a short taxable year of less than 7 days shall be added to and become a part of the following taxable year. If the short period is more than 6 days and less than 359 days the taxable income shall be annualized as provided in section 443 except that the income shall be multiplied by 365, and the result divided by the number of days in the short period. For example, a taxpayer who reports taxable income for 1953 on a calendar year basis, elects to report income for 1954 on the basis of a 52-week period ending on the Saturday nearest the end of December. The first taxable period consists of the 52-week period from January 3, 1954, to and including January 1, 1955, plus the short period of 2 days, January 1 and 2, 1954.

Subsection (f) has been made applicable to the entire title instead of the subtitle as provided in the House bill so that the 52–53-week year may be used for taxes other than income where practicable. In addition other clarifying changes have been made by your committee.

Broad regulatory authority is granted the Secretary or his delegate so that such rules as are deemed necessary may be prescribed in order to give full effect to subsection (f).

The use of books in subsection (g) is not intended to connote a requirement that records be bound. Any records sufficient to clearly reflect income will meet the requirements of this section.

Your committee has amended the House bill so that the 52-53-week fiscal year may be used for any taxable year ending after date of enactment of this act.

Section 442. Change of annual accounting period

This section is identical with section 442 of the bill as passed by the House and is derived from section 46 of the 1939 Code. If a taxpayer does not have an annual accounting period because he does not keep books and then adopts an annual accounting period other than a calendar year, there is a specific requirement that he obtain consent of the Secretary or his delegate.

A new taxpayer who must adopt an annual accounting period need not secure consent of the Secretary or his delegate under this section but may be subject to restrictions on the adoption of a taxable year contained in other sections such as section 706 (relating to taxable years of partner and partnership).

Section 443. Returns for a period of less than 12 months

This section corresponds to section 443 of the House bill.

Subsection (a) adopts the portions of section 47 of the 1939 Code relating to the circumstances under which a return for a short period must be made. Subsection (b) provides for the annualization of income in the case of a return for a short period by reason of a change in the annual accounting period. In annualizing income of a short period if the taxpayer has changed to a 52-53-week fiscal year, the provisions of section 441 (f) (2) (B) (iii) apply, and the annualization is made on a daily basis instead of a monthly basis. Subsection (b) results in no other change from section 47 (c) of the 1939 Code.

Subsection (c) is a new provision added by reason of the change of the personal exemption from a credit to a deduction. This provision limits to $600 the deduction for each personal exemption (or a deduction in lieu thereof) in the computation of tax for a short period resulting from a change of accounting period when the income and deductions are annualized.

The provisions of section 47 (e) of the 1939 Code contained in subsection (c) of the House bill have been deleted. There will be no proration of the personal exemption in the case of a return for a short period by reason of the termination of the taxable year due to jeopardy.

PART II. METHODS OF ACCOUNTING

SUBPART A—METHODS OF ACCOUNTING IN GENERAL

Section 446. General rule for methods of accounting

This section is identical with section 446 of the House bill.

This section includes the portions of section 41 of the 1939 Code relating to methods of accounting. Subsection (a) provides the general rule that the regular method of accounting used in keeping the books of the taxpayer is to be used in the computation of income for tax purposes. If the taxpayer does not have a method of accounting which is regularly used for bookkeeping purposes or if the method is one which does not clearly reflect income, under subsection (b), the computation of income for tax purposes is to be made under a method which, in the opinion of the Secretary or his delegate, does clearly reflect income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income. These provisions rearrange and clarify the provisions of the 1939 Code. It is not necessary to keep books in order to have an accounting method. In the case of a taxpayer whose sole source of income is wages, duplicate tax returns or other records may be sufficient to constitute the use of the method of accounting used in the preparation of income tax returns. Thus, the great bulk of such taxpayers who file returns on the cash basis will be considered to be using that method and hence ordinarily not subject to having their income computed on a basis which the Secretary or his delegate determines will clearly reflect income.

In subsection (c) the permissible methods of accounting subject to the provisions of subsections (a) and (b) are enumerated. All methods of accounting recognized under existing law are continued. In addition one or more hybrid methods may be authorized in the regulations issued under paragraph (4). One such method, in the case of a small retail store, will be an accrual of items affecting gross income such as purchases, sales of goods, accounts payable, and accounts receivable. In such a case items of deduction such as rent, interest, clerks' salaries, insurance and similar items may be accounted for on a cash basis. Any such hybrid method is, of course, subject to the requirements of subsection (b) that there be a clear reflection of income under the method.

Subsection (d) codifies existing case law. It appears to your committee that the House committee report is not clear as to the treatment accountingwise of the personal affairs of an individual taxpayer. Accordingly, to clarify this point your committee intends that this provision does not require that an individual taxpayer maintain his personal affairs on the same accounting method as he uses for the conduct of his trade or business although he may adopt or use a different method of accounting for each separate trade or business.

Subsection (e) codifies existing regulations. A change in the method of accounting includes a change in the general method of accounting such as a change from the cash receipts and disbursements method to an accrual method, or vice versa, or a change from the cash or an accrual method to the long-term-contract method, or vice versa. It also includes a change in the treatment of a material item such as a change in the method of valuing inventory, or a change from an accrual method without estimating expenses to an accrual method with estimated expenses, or vice versa, or a change in the method of depreciating any property. A change in the method of accounting is a substantial change as distinguished from each change in the treatment of each item. In computing taxable income, a taxpayer who changes his general method of accounting or who treats material items inconsistently must obtain the consent of the Secretary or his delegate unless an express provision of this chapter permits such change at the election of the taxpayer without such consent.

SUBPART B—TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

Section 451. General rule for taxable year of inclusion

This section is identical with section 451 of the bill as passed by the House and continues the provisions of section 42 (a) of the 1939 Code. The method of accounting employed in computing taxable income must, under section 446, be a method which clearly reflects income. The special rule in case of the death of a taxpayer who uses an accrual method makes no change in existing law.

Section 452. Prepaid income

This section corresponds to section 452 of the House bill.

Your committee has clarified this section in order to provide for instances when the liability with respect to prepaid income earned during a short period changes, and when the liability is of indefinite duration.

Under the 1939 Code, regardless of the method of accounting, with minor exceptions established by regulations or administrative practice, amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods or services to be provided by the taxpayer at a future time. Section 452 will permit the taxpayer to defer the inclusion in income of these amounts until earned in the manner required by the taxpayer's method of accounting subject to the rules and conditions prescribed in the section. The provisions of section 446 operate to require the method of accounting used in computing taxable income to clearly reflect income.

Subsection (a) (1) provides for the allocation of prepaid income which will be earned within the 5 taxable years after the year of receipt. The income is to be allocated over the period when earned in accordance with the taxpayer's method of accounting. The income need not be allocated equally. Thus if the fifth year's rent under a lease is paid in advance, the taxpayer-lessor may, instead of including the amount in income when received, elect to allocate the rent to his taxable period corresponding to the fifth year of the lease if such practice is proper under the method of accounting employed by the taxpayer. If the entire rent for the 5 years was received in advance, the rent might be apportioned pro rata over the corresponding taxable years of the taxpayer in accordance with the method of accounting. Your committee added the rule that if the liability for income to be accounted for during the short period should change, then so much of that income as not previously reported might be reported under regulations prescribed by the Secretary or his delegate. It was contemplated that this change would provide for an instance in which prepaid income, to be accounted for over a 3-year period, because the duration of liability under contract was 3 years, might, with consent of the Secretary or his delegate, be reported in the fourth, fifth, and sixth years after the year of receipt in the event an act of God intervened to extend the liability beyond the term originally set out in the contract.

Subsection (a) (2) was added by your committee to provide for the accounting of prepaid income subject to liability of indefinite duration. This change was intended to provide the benefits of this section for businesses such as those which must account for receipts from car tokens, coupons, tickets, etc. The taxpayer accounting for income under this section must determine on the basis of experience that portion of the prepaid income with respect to which the liability will cease during the taxable year of receipt and the five succeeding taxable years. That part of the income with respect to which the liability may extend beyond the sixth taxable year must be accounted for one-sixth each year, as under subsection (b). For example:

Sale of repair service coupons		$1, 000
On the basis of experience it is known that the coupons will be used as follows:		
50 percent in the first year	$500	
10 percent in the second year	100	
5 percent in the third year	50	
3 percent in the fourth year	30	
2 percent in the fifth year	20	
Total	700	
Amount to be accounted for in short period		700
Amount subject to liability of indefinite duration		300
Amount to be accounted for each year, one-sixth of $300		50

It is intended that the amount of such prepaid income to be accounted for each year may vary in accordance with the experience of the taxpayer as he periodically reassesses outstanding liabilities with respect to the prepaid income. But it is not contemplated that under any circumstances will he ordinarily be able to defer reporting any prepaid income beyond the fifth year after the year of receipt.

Subsection (b) provides for the treatment of amounts which will not be earned within 5 taxable years after the year of receipt and which the taxpayer has elected to defer under this section. The taxpayer may obtain the consent of the Secretary or his delegate to take the amounts into income in any manner. In the absence of such consent, the amounts must be taken into account ratably over the period of the taxable year of receipt and the 5 succeeding taxable years. Assume that the taxpayer receives in the first year the last year's rent on a 10-year lease. The annual rental is $6,000. The 10th year rent must be allocated $1,000 to each of the first 6 years of the lease, and with the rent attributable to the year, there would be a total of $7,000 taken into income for each of the first 6 years. In the seventh, eighth, and ninth years $6,000 will be taken into income. There will be no income in the final year. Present law would tax $12,000 in the first year—the rent attributable to the year plus the advance payment. Under subsection (b) it is possible for the Secretary or his delegate to permit the taxpayer to defer the advance payment until the 10th year when it will be earned. Conditions may or may not be imposed in the sole discretion of the Secretary or his delegate.

Subsection (c) requires the inclusion in gross income of any amount previously deferred under this section not later than the time that the obligation of the taxpayer described in subsection (e) terminates. If the taxpayer dies or goes out of existence, or if for any other reason the liability ceases, the amount deferred under this section must be taken into account in computing income for the taxable year in which such event occurs. Special rules for successor corporations are provided in section 381 (c) (7).

Subsection (d) contains the rules under which an accrual basis taxpayer may elect to be subject to the provisions of this section. The election once made is applicable to all items of prepaid income attributable to a trade or business. If the taxpayer is engaged in two or more trades or businesses, he may elect to defer all prepaid income items of any one or more of the businesses. With respect to prepaid income which will be earned within 12 months after receipt, the entire amount received may be included in gross income when received to the extent permitted under regulations prescribed by the Secretary or his delegate, even though the taxpayer has elected to defer prepaid income. The election to defer prepaid income will not apply to amounts received in taxable years beginning before January 1, 1954, even though the amounts will not be earned until after that date.

The taxpayer may make the election to defer prepaid income without consent of the Secretary for the first taxable year beginning after December 31, 1953, and ending after the date of enactment of this title in which he received prepaid income in the particular trade or business. Thus a taxpayer coming into existence in 1956 may elect, under this section, to defer prepaid income received in that year without consent. The election must be made not later than the time prescribed for the filing of the return (including extensions). If the taxpayer wishes to make an election at a later time, the consent of the Secretary or his delegate must be obtained.

Subsection (e) defines prepaid income as any amount (includible in gross income) which is received in connection with, and is directly attributable to a liability as defined in paragraph (2) and the liability extends beyond the taxable year in which the amount is received. Liability includes a liability to render services such as a television service contract if the contract is a bona fide and separate transaction and not merely a guaranty incidental to and part of the sale of a product. For treatment of items incidental to sales, see section 462. Liability also includes an obligation to furnish goods or other property or to allow the use of property such as rental property. However, prepaid income does not include income from the sale or other disposition of a capital asset or any income treated as gain from the sale of a capital asset.

Section 453. Installment method

This section corresponds to section 453 of the House bill.

Section 453 is derived from section 44 of the 1939 Code. The following substantive changes have been made.

1. Under the law as proposed in the case of a sale of realty or a casual sale of personalty, there need be no payment made in the taxable year of sale. The House bill applied the 30 percent ceiling to the year in which payments were first made but eliminated the requirement of initial payments in the year of sale. Your committee has amended the section so that a transaction may qualify whether or not there are any payments in the year of the sale provided the payments in that year do not exceed 30 percent of the selling price.

2. Under subsection (c) an adjustment is provided to eliminate the double taxation of income when a taxpayer changes from an accrual

method to the installment method. The adjustment is in the form of a reduction in tax for the year in which the item is includible the second time. The reduction is the amount of the tax attributable to the item in the prior year but not in excess of the tax attributable to the item in the year in which it is includible the second time. The tax attributable to an item is that percentage of the tax for the year which the gross profit from installment sales bears to the gross income. For example:

	Year 1	Year 2	Year 3 (year of change)
Gross profit from installment sales (receivable in 5 installments)	$100,000		[1] $20,000
		$50,000	[2] $10,000
			[3] $20,000
Other income	$80,000	$200,000	$150,000
Gross income	$180,000	$250,000	$200,000
Deductions	$60,000	$50,000	$50,000
Taxable income	$120,000	$200,000	$150,000
Assuming a tax rate of	30%	50%	40%
Tax would be	$36,000	$100,000	$60,000

[1] From year 1 sales.
[2] From year 2 sales.
[3] From year 3 sales.

Computation of adjustment

YEAR 1 ITEM

In year 3—

Tax attributable to year 1 item $=\frac{\$20,000}{\$200,000}\times \$60,000$

Tax attributable to second inclusion $6,000

In year 1—

Tax attributable to prior inclusion $=\frac{\$20,000}{\$180,000}\times \$36,000$

Tax attributable to original inclusion is $4,000

Adjustment in respect of year 1 item is $4,000

YEAR 2 ITEM

In year 3—

Tax attributable to year 2 item $=\frac{\$10,000}{\$200,000}\times \$60,000$

Tax attributable to second inclusion is $3,000

In year 2—

Tax attributable to prior inclusion $=\frac{\$10,000}{\$250,000}\times \$100,000$

Tax attributable to original inclusion is $4,000

Adjustment in respect of year 2 item is $3,000

The tax for 1954 would be reduced by $4,000 plus $3,000, a total of $7,000. The tax would then be $53,000 in year 3.

The adjustment shall be made if the change of method occurs in a taxable year beginning after December 31, 1953, for all amounts required to be included a second time without regard to whether the prior inclusion of the amount occurred in a taxable year beginning before, on, or after December 31, 1953.

3. Paragraph (4) has been added to subsection (d) as a conforming change to corporate liquidation provisions.

Section 454. Obligations issued at discount

This section is identical with section 454 of the bill as passed by the House. Subsection (a) corresponds to section 42 (b) of the 1939 Code; subsection (b) corresponds to section 42 (c) of the 1939 Code; and subsection (c) corresponds to section 42 (d) of the 1939 Code. No changes of substance have been made in these provisions.

SUBPART C—TAXABLE YEAR FOR WHICH DEDUCTIONS TAKEN

Section 461. General rule for taxable year of deduction

This section corresponds to section 461 of the House bill.

Section 461 adopts the provisions of section 43 of the 1939 Code in rearranged form. The timing of deductions and credits otherwise allowable is determined by the taxpayer's method of accounting. The method must clearly reflect the income of the taxpayer.

Subsection (c) is new. Your committee has provided that real property taxes which relate to a definite period of time may, at the election of an accrual basis taxpayer, be treated as accruing ratably over that period. Under present law the tax is deemed to accrue at some definite moment which is determined by reference to State or local law fixing when the tax becomes a lien on the property or when personal liability for the tax arises or on some other basis. Under the amended provision, if the taxpayer does not make the election, the result reached under present law will not be affected. Under the bill if the election is made a real property tax for the calendar year 1954 regardless of when due, when a lien, or when the taxpayer becomes personally liable for the tax shall be treated as accruing ratably over the period for which the tax is levied.

The special rules are necessary to cover the transition from prior law to the new elective rule so that (1) the same tax may not be deducted more than once, and (2) a deduction, otherwise proper, shall not be denied.

Section 462. Reserves for estimated expenses

This section corresponds to section 462 of the House bill.

Subsection (a): Your committee has added to the provision in the House bill that the addition to each reserve for estimated expenses shall be taken into account, in the discretion of the Secretary or his delegate. The grant of discretionary authority to the Secretary is similar to the provision relating to reserves for bad debts under section 166 (c). Subsection (b) provides that at the close of each taxable year any excess in such reserve shall be taken into account in that year in accordance with regulations. Any excess may be credited to income or it may have the effect of reducing a deduction that would otherwise be allowable, but only in the year in which facts and circumstances become known which cause the reserve to be excessive.

Subsection (c) provides that the taxpayer must make an election to treat expenses in his trade or business on an estimated basis. The mechanics of making the election are to be prescribed by regulations. No such election may be made by taxpayers using the cash receipts and disbursements method of accounting. The reserve method of treating estimated expenses may be elected by the taxpayer without consent of the Secretary for the first taxable year (1) which begins after December 31, 1953, and ends after the date of enactment of this bill, and (2) for which there are expenses which may be estimated reasonably in the trade or business. The election shall be made not later than the time prescribed for filing the return, including extensions. Thus a taxpayer coming into existence in 1955 who has expenses which qualify under this section for the first time during 1956, may elect in his return for 1956 to establish reserves for such expenses. An election under this section may be made at any time with the consent of the Secretary or his delegate.

Subsection (d) defines the expenses which may be estimated in the taxable year as those which would (but for this section) be required to be taken into account for a subsequent taxable year. The expenses must be related to the income of the taxable year or prior years in which expenses were estimated in accordance with this section. Expenses attributable to income of future years are not to be taken into account in computing an addition to a reserve in the taxable year. The Secretary or his delegate must be satisfied that the expenses can be estimated with reasonable accuracy. For example, if cash discounts are allowed customers for prompt payment, and the taxpayer can predict from experience the approximate percentage of the allowable discounts which will be taken (even though he cannot name the customers with certainty) he will be permitted a deduction in the year in which the sales are reported equal to the discounts which will be realized in the process of collecting the accounts. If repairs or replacements will have to be made under guaranty on products sold during the year, and the average cost of such repairs or replacements can be estimated with reasonable accuracy, the taxpayer may take as a deduction in the year of such sales a reasonable addition to a reserve for product guaranties. The balance in the reserve at the close of each taxable year must be adjusted to reflect the estimated liability of the taxpayer with respect to outstanding guaranties. Other illustrative items for which such reserves might be set up in appropriate cases include sales returns and allowances, freight allowances, quantity discounts, vacation pay, and certain liabilities for self-insured injury and damage claims. The Secretary or his delegate may disallow additions to any reserve of this type if he finds that the costs and expenses for which provision is made are not reasonably supported by the taxpayer.

Example: Taxpayer selling air-conditioning units guarantees the product, including parts, for 1 year subsequent to sale. Taxpayer's experience indicates that the average cost of fulfilling the guaranty is as follows:

Labor, 6 hours, at $2	$12
Material and parts	8
Overhead (including allocable part of truck depreciation and maintenance expenses—20 miles, at 20 cents per mile)	4
Total	24

For each unit sold $24 would be deducted as a cost of the sale and set up in a reserve account. As the expenses are actually incurred each month, the reserve would be decreased so that, with respect to each contract, the reserve would be eliminated over the guaranty period. At the close of each taxable year the reserve would be adjusted to reflect changes in the cost experience of the taxpayer.

The particular costs and expenses which are the basis for the addition to the reserve are not to be considered as having been incurred prior to the time that they actually take place. The addition to each reserve is allowable as a single item in 1 year, and a portion of such reserve must be returned to income or used to reduce expenses in subsequent years when the expense is actually incurred. In the example above, the depreciation on the truck would be taken and basis adjusted, as it would have been taken care of were it not for this section; and the fact that it was considered in establishing the reserve does not permit a double deduction. With respect to items involving related reserves, only one deduction against taxable income will be allowed to reflect expense actually incurred.

The reserve method is not to be allowed for costs and expenses of a contingent or contested nature and as to which there is no reasonable certainty of their amount. Reserves created for general undetermined contingencies, indefinite possible future losses, expenses and losses not reasonably related to the taxable year, or for specific expenses and losses that are being contested or are in litigation, cannot ordinarily be estimated with reasonable accuracy and are not to be the basis for additions to reserves under this section.

Subsection (d) (2) provides for additional exceptions. This reserve method is not to be available for any deduction attributable to income taken into account in taxable years preceding the first taxable year for which the election under this section is made. A deduction is not allowable for an addition to or the creation of reserves for estimated expenses attributable to prepaid income which the taxpayer has elected to defer under section 452. This section specifically excludes deductions relating to bad debts which continue to be provided for under section 166.

Your committee has clarified the deductibility of expenses related to income for taxable years preceding the taxable year in which the election is made to establish reserves for estimated expenses. Such expenses will be deductible when incurred.

SUBPART D—INVENTORIES

Section 471. General rule for inventories

This section is identical with section 471 of the bill as passed by the House. It corresponds to section 22 (c) of the 1939 Code. No changes of substance have been made.

Section 472. Last-in, first-out inventories

This section is identical with section 472 of the bill as passed by the House. It corresponds to paragraphs (1) to (5), inclusive, of section 22 (d) of the 1939 Code. These provisions have been rearranged in part but there are no changes of substance.

PART III. ADJUSTMENTS

Section 481. Adjustments required by changes in method of accounting

If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deduction is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doubling ups which are due to the change in method which must be adjusted.

Under present law these adjustments are made whenever the taxpayer requests permission to change his method of accounting. Where the Commissioner forces a taxpayer to change his method of accounting because the old method does not clearly reflect income, various court decisions have denied the Commissioner the right to make the necessary adjustments.

Under the House bill for taxable years beginning after December 31, 1953, if the taxpayer changes his method of accounting, voluntarily or involuntarily, adjustments will be made in the year of the change. Under your committee's amendments no part of the transitional adjustments will be based on items that were, or should have been, under the proper method of accounting, taken into account as an income-producing factor for taxable years to which subtitle A of the 1954 Code does not apply. It is contemplated that such transitional adjustments as are required will take into account inventories, accounts receivable, and accounts payable, but that they should not be limited to those categories. If the adjustments increase the taxable income by more than $3,000, the tax attributable to the adjustment shall not exceed the tax which would have resulted if the adjustment had been included ratably in the taxable year of the change and the 2 preceding taxable years. This special limitation only applies if the taxpayer used the old method in the 2 preceding taxable years.

An alternative limitation on the tax attributable to the adjustment has been added to the House bill. This limitation will apply only if the adjustments increase the taxable income by more than $3,000. The alternative computation provided under this paragraph operates as a further limitation on the tax attributable to the adjustment computed under subsection (a) as limited by paragraph (1) of this subsection. This limitation applies only if the taxpayer can establish his taxable income for one or more taxable years consecutively preceding the taxable year of the change under the new method of accounting. The sum of the net increase or decrease in tax for the years preceding the year of change from the tax computed for those years under the old method of accounting plus the net increase in the tax in the year of change attributable to the balance of the adjustments not allocated to the prior years under the recomputation operates as a ceiling on the tax attributable to the adjustments. For purposes of the recomputation, net operating losses affecting the computation of tax for any prior taxable year not otherwise recomputed under this paragraph shall in all cases be taken into account. If any taxable year involved in a computation under this paragraph is a closed year, the increase or decrease in tax shall be based upon the tax previously determined for that year in accordance with section 1314 (a).

The following example will illustrate the application of this section to a situation in which an individual taxpayer using the cash method on a calendar-year basis changes to the accrual method for the year 1960. The result would be the same whether the change was requested by the taxpayer or compelled by the Secretary or his delegate in the course of an audit in 1961 or in some later year of the taxpayer's return for 1960.

On January 1, 1960, taxpayer had in his store, merchandise which cost $2,500. On December 31, taxpayer had a closing inventory of $6,000. Purchases during the year amounted to $22,500, and net sales were $30,000. Total deductible business expenses were $5,000. The computation of taxable income with the use of inventories for 1960 would be made, assuming no other relevant items, as follows:

Net sales	$30, 000
Opening inventory	2, 500
Purchases	22, 500
Total	25, 000
Less closing inventory	6, 000
Cost of goods sold	19, 000
Gross profit	11, 000
Deductions	5, 000
Business income	6, 000
Deduction for personal exemption and standard deduction	1, 200
Taxable income	4, 800

Adjustments.—The opening inventory had been deducted in prior years subsequent to 1953 under the cash method. In order to prevent the same item from twice reducing taxable income, a $2,500 adjustment must be made to taxable income. Taxable income is increased to $7,050. The special limitation in subsection (b) is not applicable because the increase in taxable income is not in excess of $3,000.

Assuming that $1,000 of the opening inventory of $2,500 had been deducted under the cash method, in years prior to 1954, then the adjustment is only $1,500 and, the taxable income in the year of the change would amount to $6,150.

Assuming that the adjustment is $3,600, one of the conditions necessary for subsection (b) to be applicable would be met. If the 2-year requirement of paragraph (1) is also satisfied, the tax in 1960 attributable to the $3,600 adjustment in 1960 cannot exceed the tax which would result from the inclusion of $1,200 in 1960, $1,200 in 1959, and $1,200 in 1958. The alternative limitation in paragraph (2) would apply only if the taxpayer can establish his income for one or more taxable years consecutively preceding 1960 on an accrual method. Assuming that this can be done and that the only difference in result between the two methods is due to the deduction under the cash method for purchases of inventory in years subsequent to 1953, by recomputing the tax for each of the years under the accrual method back to the year in which the inventory accumulation began, a portion of the adjustment is allocated to each of the years. The cumulative effect of all the increases and decreases in tax liability for the years recomputed is another limit on the tax resulting from the adjustments in the year of change. If all of the adjustments are not absorbed in the recomputation, the balance is taken into account in the year of change. The tax attributable to the adjustment is to be determined under subsection (a), but shall where subsection (b) (1) or (2) or both are applicable never exceed the lesser of the tax under subsection (a) or paragraph (1) or (2) of subsection (b).

Subsection (c) permits the Secretary, or his delegate, to provide alternative methods for including the adjustments required by this section. Adjustments may be taken into account in any period which is agreed upon by the Secretary or his delegate and the taxpayer.

Subsection (d) makes this section inapplicable in case of a change from an accrual to the installment method. In such case the rules provided in section 453 (c) apply.

Section 482. Allocation of income and deductions among taxpayers

This section is identical with section 482 of the bill as passed by the House. It corresponds to section 45 of the 1939 Code. No substantive changes have been made.

SUBCHAPTER F—EXEMPT ORGANIZATIONS

The provisions of subchapter F, which include sections 501 through 526, continue, with the exceptions described below, the provisions of the 1939 code relating to the general exemption from tax for certain organizations, such as religious, charitable, and educational organizations, and the provisions imposing a tax on the business income of certain otherwise tax-exempt organizations. As in the House bill, certain employee trusts will be subject to the provisions of sections 503, 511, 513, and 514, but these trusts are not described in this subchapter as in the House bill. The House bill provided a change in the definition of long-term business lease which is further modified in your committee's bill. In addition some special rules for the application of these sections to employee trusts have been added by your committee.

Part I—General Rule

Section 501. Exemption from tax on corporations, certain trusts, etc.

This section is derived from sections 101 and 421 of the 1939 Code and section 501 of the House bill. As in the House bill the exemption from tax of certain employee pension, profit-sharing, and stock-bonus trusts is provided by subsection (a) of this section. The description of these trusts is in section 401 (a) of your committee's bill, however, instead of in section 501 (c) as in the House bill.

A further amendment in your committee's bill is the addition in section 501 (c) (3) of organizations devoted to testing for public safety. This language is intended to govern organizations which test consumer products, such as electrical products, to determine their acceptability for use by the general public. The restriction of paragraph (3) will apply, namely, that no part of the benefit may inure to a private individual or shareholder and propaganda or influencing of legislation may not be a major activity.

Section 502. Feeder organizations

This section is identical with section 502 of the House bill and was derived from section 101 of the 1939 Code.

Section 503. Requirements for exemption

This section corresponds to section 3813 of the 1939 Code except that under this section a stock bonus, profit-sharing or pension trust would lose its exemption from tax under section 501 (a) for certain taxable years if it engaged in a prohibited transaction after March 1, 1954. For example, if the trust loaned any part of its income or corpus to the employer-creator of the trust without the receipt of adequate security and a reasonable rate of interest, it would lose its exempt status.

This section is substantially similar to section 503 of the House bill except for the application of this rule to stock bonus, profit-sharing and pension trusts that on March 1, 1954, held notes or other evidences of indebtedness representing loans made without adequate security or without a reasonable rate of interest. If the note is payable on a date certain it may be held to maturity. If that payment date falls prior to December 31, 1955, the note may be renewed on the same terms for a period not extending beyond December 31, 1955. In the case of notes payable only on demand the mere continuation of the note beyond December 31, 1955, without adjusting the terms to accord with the requirements of adequate security and reasonable interest will be deemed a prohibited transaction.

Section 504. Denial of exemption

This section corresponds to section 504 of the House bill and to section 3814 of the 1939 Code.

Paragraph (1), which continues present law, specifies as a cause for the denial of exemption, accumulations of income which are unreasonable in amount or duration for carrying out the function or purpose of the organization claiming the exemption.

An amendment to the House bill makes it clear that paragraph (1) will not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. It is further provided in the amendment made by your committee that in the case of a trust created by the will of a decedent dying on or after January 1, 1951, where income is required to be accumulated under the mandatory terms of the will created by the trust, the rule of paragraph (1) will only apply to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

Another amendment made to the House bill by your committee renders section 504 inapplicable to an employee trust.

Part II—Taxation of Business Income of Certain Exempt Organizations

Section 511. Imposition of tax on unrelated business income of charitable, etc., organizations

This section corresponds to section 421 of the 1939 Code with new provisions added to apply to certain trusts. It is substantially similar to section 511 of the House bill. A stock bonus, profit-sharing, or pension trust, although exempt from tax under section 501 (a), would be subject to the tax imposed by section 511 with respect to its income from any unrelated trade or business. For this purpose, section 513 (b) provides that the term "unrelated trade or business" means, in the case of a trust described in section 401 (a) which is exempt from tax under section 501 (a), any trade or business regularly carried on by such trust or by a partnership of which it is a member. This provision prevents an employees' trust from advancing the contention that a trade or business in which it engages is not an unrelated trade or business on the ground, for example, that its trust agreement authorizes it to engage in the particular trade or business involved.

Under section 511 (c) the tax imposed on the unrelated business income of an employees' trust would apply only to taxable years beginning after June 30, 1954. No other substantive changes have been made.

Section 512. Unrelated business taxable income

This section is derived from sections 421 (c), 421 (d) and 422 of the 1939 Code and section 512 of the House bill. No substantive changes have been made. Subsection (b) (11) has been amended to conform with the amendments in section 170 which permit the charitable deduction of an individual, or a trust subject to individual rates, to exceed 20 percent of income in the case of certain types of contributions.

Section 513. Unrelated trade or business

This section corresponds to section 422 (b) of the 1939 Code and section 513 of the House bill. No substantive changes have been made.

Section 514. Business leases

This section corresponds to section 423 of the 1939 Code and section 514 of the House bill relating to the treatment, as unrelated business net income, of certain rents received by certain tax-exempt organizations. With some exceptions, this section is the same in substance as existing law although considerable rearrangement has been effected.

Under existing law a lease constitutes a supplement U lease (redesignated as a "business lease" under this section) only if the lease is for a term of more than 5 years. A special provision treats as a lease for more than 5 years one which contains an option for renewal or extension. These rules are unchanged and are set forth in section 514 (b) (2) (A). Section 514 (b) (2) (B) contains a new rule under which a lease is treated as continuing for more than 5 years where the property has been occupied by the same lessor for a total period of more than 5 years (commencing not earlier than the date of acquisition of the property by the tax-exempt organization or trust) whether the occupancy is under one or more leases, renewals, extensions, or continuations. This provision, however, shall have application only in the sixth and succeeding years of such occupancy. Thus, if a tenant occupies the premises under a series of leases, or continues to occupy the premises on an informal basis after one or more leases, his occupancy after the first 5 years shall be treated as though it was under a lease for more than 5 years. Continued occupancy shall be considered to be by the same lessor if the occupants during the period are so related that losses in respect of sales or exchanges of property between them would be disallowed under section 267 (a).

Section 423 (a) of the 1939 Code contains an exception to the treatment of rents from leases of more than 5 years where a large part of the property is leased under short-term leases. Under this exception where part of the property is leased for more than 5 years and part is leased for less than 5 years, the long-term leases are treated as supplement U leases only if (1) the rents from the property under the long-term leases will be 50 percent or more of the total rents or the area occupied under the long-term leases represents 50 percent or more of the total area of the real property; or (2) the rent derived from any one tenant under a long-term lease (or from an affiliated group) represents more than 10 percent of the total rents or the area occupied by one such tenant or group of tenants represents more than 10 percent of the total area. This exception is continued in subsection (b) (3) (B) of this section.

In addition, two special rules are provided for determining, under section 514 (b) (3) (B) (i), whether or not the rents derived from the real property under leases for more than 5 years represent 50 percent or more of the total rents from the property, or the area of the premises occupied under leases for more than 5 years represents 50 percent or more of the total area of the property rented. In the first place, the rule in subsection (b) (2) (B) which deems continuous occupancy over 5 years to be a long-term lease after the fifth year is not applied. This exception is provided in the House bill. A further sentence is added to subsection (b) (3) (B) by your committee to provide that in this case, if a lease is renewed during the last half of its term, the unexpired portion of the first lease will not be added to the second lease to determine whether or not the second lease is long term. For example, 60 percent of the total rents may be paid (and 60 percent of the premises may be occupied) by tenants who have leases for exactly 5 years, and no one of the remaining tenants on a long-term lease pays over 10 percent of the rents or occupies over 10 percent of the premises. None of these leases will be deemed to be business leases (supplement U leases). This result will continue even though it may be the custom for the 5-year tenants to sign a new lease at the end of the third year of their current lease to take effect at the close of the current lease. They will at that time have the premises leased for a period of 7 years into the future but the unexpired part of the first lease may not be tacked to the second lease for the application of the 5-year test. This does not apply to renewal options in the first lease.

Two special rules are added to subsection 514 (c) which are directed toward the definition of business lease indebtedness in the case of pension, profit-sharing, and stock-bonus trusts. It is the ratio of business lease indebtedness to basis that determines the proportion of the rental income from the lease that is subject to tax. Paragraph (5), added by your committee, provides that if such an employees' trust, prior to March 1, 1954, incurs what would have been business-lease indebtedness in connection with property which is leased by that date then the indebtedness will not be deemed to be business-lease indebtedness for the purposes of this section. Further, any indebtedness incurred on or after March 1, 1954, necessary to carry out the terms of a lease made before March 1, 1954, shall not be deemed business-lease indebtedness. For example, if a lease was made before March 1, 1954, and indebtedness incurred on or after such date to construct a factory required for such lease, such indebtedness would not be treated as business lease indebtedness.

The second special rule deals with amounts borrowed by a pension, profit-sharing, or stock-bonus trust of an employer from another trust of the same employer. These will only be treated as indebtedness of the borrowing trust to the extent that the lending trust had to borrow to make the loan. The tests of the relationship between any borrowing of the lending trust and the particular loan to the brother trust are the same as the tests provided in subsection (c) (1) of relationship between borrowing and the acquiring or improving of real property. If a certain loan is deemed to be indebtedness of the borrowing trust, whether it is business-lease indebtedness depends on whether or not the borrowing trust acquired the loan in connection with acquiring or improving of real property (as described in subsection (c) (1)).

Section 515. Taxes of foreign countries and possessions of the United States

This section is identical with section 515 of the House bill and was derived from section 424 of the 1939 Code. No substantive changes have been made.

PART III—FARMERS' COOPERATIVES

Section 521. Exemption of farmers' cooperatives from tax

This section is identical with section 521 of the House bill and was derived from paragraph (12) (A) of section 101 of the 1939 Code.

Section 522. Tax on farmers' cooperatives

This section is identical with section 522 of the House bill and was derived from paragraph (12) (B) of section 101 of the 1939 Code.

PART IV—SHIPOWNERS' PROTECTION AND INDEMNITY ASSOCIATIONS

Section 526. Shipowners' protection and indemnity associations

This section is identical with section 526 of the House bill and was derived from section 116 (g) of the 1939 Code.

SUBCHAPTER G—CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

PART I. CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

IN GENERAL

Part I (including secs. 531–536) corresponds to section 102 of existing law, and imposes a special tax on any corporation, not specifically excepted, formed or availed of for the purpose of avoiding the income tax on shareholders.

Section 531. Imposition of accumulated earnings tax

This section, which corresponds to section 102 (a) of existing law and is identical to section 531 of the House bill, imposes a tax on the accumulated taxable income of a corporation improperly accumulating earnings and profits. The term "accumulated taxable income" is defined in section 535.

Section 532. Corporations subject to accumulated earnings tax

This section corresponds to section 532 of the House bill. It corresponds in part to section 102 (a) of existing law and provides that the tax imposed by section 531 shall be applicable to every corporation, formed or availed of for the purpose of avoiding the income tax with respect to its shareholders.

The provision of the House bill excepting publicly held corporations from the accumulated earnings tax has been deleted by your committee. With this amendment, the list of excepted corporations conforms to existing law.

Section 533. Evidence of purpose to avoid income tax

This section corresponds to section 533 of the House bill and to section 102 (b) and (c) of the present law, provides a presumption that any corporation which permits its earnings and profits to accumulate beyond the reasonable needs of the business has been formed or availed of for the purpose of avoiding income tax on its shareholders.

The reference to "reasonably anticipated" needs of the business has been deleted from section 533 (a) and incorporated in new section 537.

Section 534. Burden of proof

This section, which corresponds to section 534 of the House bill except for technical amendments, is similar to a provision in H. R. 6712, 80th Congress, which was reported and passed by the House of Representatives in 1948.

The section, as amended by your committee, provides that in certain cases before the Tax Court the burden of proving that all or any part of an accumulation of earnings and profits is in excess of reasonable needs of the business shall be on the Secretary or his delegate. Under present law, the burden of proof is on the taxpayer. The bill provides that in order for the burden of proof to be shifted, the taxpayer, having received notification from the Secretary or his delegate that it is intended to assess a deficiency based in whole or in part on the accumulated earnings tax, must submit a statement indicating why the needs of the business require the retention of earnings and profits, together with facts sufficient to show the basis thereof. If the taxpayer does not file such a statement, he must bear the entire burden of proof as under existing law. In addition, if the taxpayer presents grounds in his statement which are not supported by facts sufficient to show the basis thereof, the burden of proof with respect to such grounds must be borne by the taxpayer. If the Secretary or his delegate fails to give the taxpayer notification prior to the issuance of a notice of deficiency (except in the case of a notice issued after a jeopardy assessment), then the Secretary or his delegate must bear the burden of proof even though the taxpayer has filed no statement.

This section, as amended, is applicable only with respect to a notice of deficiency for a taxable year to which the subtitle applies and which is mailed more than 90 days after the date of enactment of this title.

The technical amendments made by your committee make clear that the shift in the burden of proof under secion 534 applies where the issue between the Government and the taxpayer relates to the portion of the earnings and profits which may be accumulated during the taxable year for the reasonable needs of the business. Under the amendment made by your committee to section 535 (c), the portion of the earnings and profits for the taxable year which are retained for the reasonable needs of the business is not subject to the accumulated earnings tax.

Section 535. Accumulated taxable income

This section is similar to section 535 of the House bill. Technical amendments have been made in subsections (a) and (b). Subsection (c), relating to the accumulated earnings credit, has been amended in substance, as described below.

Subsection (a) defines "accumulated taxable income," i. e., the amount which is subject to the accumulated earnings tax, and basically is a combination of the adjustments required in computing "section 102 net income" and "undistributed section 102 net income" of the present law. The accumulated taxable income is the taxable income of the corporation after applying the adjustments provided in subsection (b), minus the sum of the dividends paid deduction as defined in section 561 and the accumulated earnings credit.

In adjusting taxable income, subsection (b), as amended by your committee, provides that the following deductions are allowed:

(1) Taxes accrued during the taxable year. The taxes which are deducted include Federal income and excess-profits taxes (but not World War II excess-profits taxes); and income, war-profits, and excess-profits taxes of a foreign country or a possession of the United States (to the extent not taken as a deduction in computing taxable income under section 164 (b) (6)); but do not include the accumulated earnings tax, the personal holding company tax, or similar taxes imposed by corresponding sections of prior income-tax law. Present law has been amended to provide an adjustment for taxes of a foreign country or a possession of the United States included in the computation of the corporation's foreign tax credit and not taken as a deduction by such corporation in computing its taxable income.

(2) Charitable contributions which are disallowed in computing taxable income. This adjustment permits the deduction of all charitable contributions which would otherwise be allowable to corporations under section 170 except for the percentage limitation contained in section 170 (b) (2).

(3) Capital losses which are disallowed under section 1211 (a) in computing taxable income.

(4) The excess of net long-term capital gains over net short-term capital losses minus the taxes attributable to such excess. A technical amendment by your committee allows the capital-gains tax as a deduction in computing accumulated taxable income but reduces the amount of the deduction for capital gains by the taxes attributable to such gains. This amendment conforms to present law.

(5) The deduction allowed to bank affiliates described in section 601.

In adjusting taxable income, subsection (b) further provides that the following deductions are not allowed:

(1) The special deduction for corporations provided in part VIII (except section 248) of subchapter B. The deductions which are disallowed include the deductions for partially tax-exempt interest and for dividends received.

(2) The net operating loss deduction provided in section 172. It may be noted that the 1-year net operating loss carryover allowed in section 26 (d) of existing law in computing the basic surtax credit will no longer enter into the computation of the amount of earnings subject to the accumulated earnings tax.

(3) The capital loss carryover provided in section 1212.

Subsection (c), relating to the accumulated earnings credit allowed in computing the accumulated taxable income, has been amended by your committee in two principal respects. The amendment increases to $60,000 the minimum amount of earnings and profits which a corporation may accumulate before being subject to the accumulated earnings tax. The accumulated earnings credit has also been expanded to include the portion, if any, of the earnings and profits of the current taxable year which are retained for the reasonable needs of the business.

Under subsection (c), as revised, the accumulated earnings credit, in the case of a corporation other than a mere holding or investment company, is an amount equal to the excess of such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business over the deduction allowed by subsection (b) (6) for long-term capital gain. The amount of the earnings and profits which are retained during any taxable year is the amount by which the earnings and profits for such year exceed the dividends paid deduction (as defined in section 561) for such year. In determining the portion, if any, of the earnings and profits for a taxable year which may be retained for the reasonable needs of the business, the amount of the earnings and profits accumulated in prior years shall, of course, be taken into account.

Subsection (c), as revised, further provides that, in the case of a corporation other than a mere holding or investment company, the accumulated earnings credit shall not be less than the amount by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. If the accumulated earnings and profits of the corporation at the close of the preceding taxable year are equal to or exceed $60,000, this minimum credit will have no effect on the computation of the accumulated earnings credit.

The accumulated earnings credit in the case of a corporation which is a mere holding or investment company is the amount, if any, by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. If such accumulated earnings and profits at the close of the preceding taxable year are equal to or exceed $60,000, a corporation which is a mere holding or investment company will have no accumulated earnings credit.

The accumulated earnings and profits of a corporation at the close of a preceding taxable year, for purposes of the computations required by subsection (c), shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such year.

The allowance of the minimum credit shall not in any way create an inference that accumulations in excess of $60,000 are unreasonable in relation to the needs of the business. The minimum credit is subject to restrictions in the case of multiple corporations formed to avoid income tax.

Section 536. Income not placed on annual basis

This section is identical with section 536 of the House bill.

This section corresponding to section 102 (f) of present law provides that, in computing the accumulated earnings tax, income shall not be placed on an annual basis where a return for a short taxable year is filed.

Section 537. Reasonable needs of the business

This section corresponds to part of section 533 (a) of the House bill. It provides that, in determining whether earnings and profits have been permitted to accumulate beyond the reasonable needs of a business for purposes of this part, reasonably anticipated needs of a business must be considered. It is intended that this provision will make clear that there is no requirement that the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax.

Part II. Personal Holding Companies

IN GENERAL

Part 2 (including sections 541–547) corresponds to s..tions 500–511 of existing law, and imposes a special tax on the undistributed income of personal holding companies. Several amendments have been made to relieve inequities, to clarify and simplify certain provisions, and to provide for a more effective administration of the tax.

Section 541. Imposition of personal holding company tax

This section is identical with section 541 of the House bill.

This section, corresponding to section 500 of existing law, imposes a tax upon the undistributed personal holding company income of every personal holding company. The term "undistributed personal holding company income" is defined in section 545.

Section 542. Definition of personal holding company

This section, which corresponds to section 501 of existing law and is substantially the same as section 542 of the House bill, defines a "personal holding company" as any company (not otherwise specifically excepted) if at least 80 percent of its gross income for the taxable year is personal holding company income and if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals.

Subsection (a) (1) represents a substantial simplification of section 501 (a) (1) of present law which provides that once a corporation is classified as a personal holding company and the 80 percent of gross income test is met, the gross income requirement in the 3 subsequent years is only 70 percent in lieu of 80 percent. Under the House bill and your committee's bill, a single 80-percent test is established.

Subsection (a) (2), relating to the stock ownership test, has been modified to provide that organizations described in section 503 (b) and certain trusts described in section 642 (c), owning stock in the corporation, are considered as an individual. Thus, if 50 percent of the stock of a corporation is owned by a tax-exempt organization described in section 503 (b), such corporation is a personal holding company for purposes of applying the stock ownership requirement.

Subsection (a) of your committee's bill is identical to the corresponding provision of the House bill except for a technical amendment.

Subsection (b) provides that in the case of certain affiliated corporations filing a consolidated return the personal holding company tax shall not apply unless the gross income of tl group meets the gross income requirement. Under present law this treatment is available only to railroad corporations. The provision, as revised by your committee, extends the same treatment, with two exceptions, to any group of affiliated corporations filing a consolidated return.

Paragraph (2) provides that the consolidated treatment is not available to an affiliated group of corporations, other than a railroad group, if any member of the group (including the common parent) derived 10 percent or more of its gross income from sources outside the affiliated group and if 80 percent or more of such income from outside sources consists of personal holding company income under section 543. In applying section 543 for this purpose, the income from outside the group shall be treated as if it were the entire income of such corporation. For the purpose of applying these income tests to the common parent corporation, there shall be disregarded dividends from another corporation in which the common parent owns more than 50 percent of the voting stock and which is not a personal holding company.

Paragraph (3) includes the application of subsection (b) if any member of the group (including the common parent) is exempt from the definition of personal holding company.

The committee amendment deletes a requirement of the House bill that, in order to qualify for the consolidated treatment, the common parent corporation of other than an affiliated group must derive 80 percent or more of gross income from other members of the group for a 3-year period. The amendment also permits a corporation in the group to receive an insignificant amount of personal holding company income from outside the group without disqualifying the group.

Subsection (c), corresponding to section 501 (b) of existing law, lists the corporations which are excepted from the personal holding company tax. Subsection (c) (10), relating to the exclusion of certain foreign corporations, places into the law a rule already contained in the personal holding company regulations (section 39.500–1 (b) of Regulations 118).

Section 543, Personal holding company income

This section lists those items which are included in personal holding company income, and corresponds to section 502 of existing law. The section corresponds to section 543 of the House bill except for an amendment to section 543 (a) (1) and (6).

The amendment to section 543 (a) (1) excludes from personal holding company income interest on amounts set aside in reserve funds under section 511 or 607 of the Merchant Marine Act, 1936.

Subsection (a) (6), relating to the inclusion in personal holding company income of rental income received from corporate shareholders, is qualified to limit application of the paragraph to cases in which the corporation has other personal holding company income in excess of 10 percent of its gross income. An amendment by your committee to this section makes clear that other rental income is to be disregarded in applying the limitation in the last sentence of subsection (a) (6).

Subsection (b) includes in gross income and personal holding company income only the excess of gains over losses with respect to gains from stock and securities transactions and commodities transactions.

Subsection (c) is the same as existing law and defines "gross income" in the case of an insurance company other than life or mutual.

Section 544. Rules for determining stock ownership

This section, which is similar to section 503 of existing law and is identical with section 544 of the House bill, sets forth the rules with respect to constructive ownership of stock and convertible securities.

Section 545. Undistributed personal holding company income

This section is substantially the same as section 545 of the House bill. Technical amendments are noted below.

Subsection (a) defines "undistributed personal holding company income," i. e., the amount which is subject to the personal holding company tax, and basically is a combination of the adjustments required in computing "subchapter A net income" and "undistributed subchapter A net income" of the present law. The undistributed personal holding company income is the taxable income of the corporation after applying the adjustments provided in subsection (b), minus the dividends paid deduction as defined in section 561.

In adjusting taxable income, subsection (b), as amended by your committee, provides that the following deductions are allowed:

(1) Taxes accrued during the taxable year. The taxes which are deductible include Federal income and excess profits taxes (but not World War II excess profits taxes); and income, war profits, and excess profits taxes of a foreign country or a possession of the United States (to the extent not taken as a deduction in computing taxable income under section 164 (b) (6)); but do not include the accumulated earnings tax, the personal holding company tax, or similar taxes imposed by corresponding sections of prior income tax law. The changes made in existing law include (*a*) an al'owance of the deduction only in the taxable year in which such taxes accrue, and (*b*) allowance of a deduction for taxes included in a corporation's foreign tax credit, and not taken as a deduction in computing taxable income. In allowing a deduction only for taxes accrued, the committee recognizes that some corporations on the cash basis have consistently deducted, in returns filed for prior taxable years, only those taxes which have been paid during such years. Such corporations may continue to so deduct only the taxes paid during the taxable year. However, such a corporation may deduct only the taxes accrued during the taxable year if it so elects on its return filed for such year. An election once made in a return is irrevocable for such year and the accrual method of deducting taxes applies to all subsequent taxable years. In the case of contested taxes the accrual occurs in the year the contest is resolved (*Dixie Pine Products Co.* v. *Commissioner,* 320 U. S. 516).

(2) Charitable contributions. This section allows a corporation to deduct, in computing its undistributed personal holding company income, charitable contributions to the same extent as allowed an individual in section 170. In lieu of the adjusted gross income in making such computation there shall be employed the taxable income of the corporation computed as provided in section 170 (b) (2). An amendment by your committee clarifies the application of the charitable limitation and conforms to exist-

ing law with respect to certain deductions disallowed under section 545 (b) (8).

(3) The net operating loss for the preceding taxable year. Under present law a 1-year net operating loss carryover is allowed a personal holding company in computing its dividends paid credit under section 27 (a). Inasmuch as this bill alters the concept of the dividends paid credit, a net operating loss deduction for the preceding taxable year is not allowed in computing the dividends paid deduction, but is allowed as an adjustment to taxable income.

(4) The excess of the net long-term capital gains over the net short-term capital losses. Under present law, the alternative capital gains tax is imposed in lieu of the income and personal holding company taxes. This adjustment reaches the same result. A technical amendment by your committee to the House bill allows the capital gains tax as a deduction in computing undistributed personal holding company income but reduces the amount of the deduction for capital gains by the taxes attributable to such gains.

(5) The deduction allowed to bank affiliates described in section 601.

(6) The amount used or irrevocably set aside to pay or retire indebtedness of any kind incurred prior to January 1, 1934.

(7) The amount of a lien in favor of the United States. Under present law a corporation, in computing undistributed subchapter A net income, is allowed a deduction of the amount by which the undistributed subchapter A net income exceeds the amount which could be distributed on the last day of the taxable year as a dividend (1) without violating the Trading With the Enemy Act or the First War Powers Act, 1941, and (2) not subject to a lien in favor of the United States. No provision is made for the inclusion of the deductible amounts in subchapter A net income when the earnings are no longer subject to the restrictions of the Trading With the Enemy Act or the First War Powers Act, 1941, and a lien in favor of the United States. The bill provides that only the amount of the lien shall be deducted from taxable income and that such amount shall be included in taxable income for the taxable year in which the lien is satisfied or released. The amount included in taxable income in the year the lien is released or satisfied is only the amount which has been deducted under this paragraph, and does not include amounts which were allowed as deductions under section 504 (e) of the 1939 Code. Shareholders of the personal holding company may elect to compute the income tax with respect to such dividends as are attributable to the amount which is added to taxable income as though such dividends were received ratably over the period the lien was in effect.

In adjusting taxable income, subsection (b), as amended by your committee, further provides that the following deductions are not allowed:

(1) The special deductions for corporations provided in part VIII (except sec. 248) of subchapter B. The deductions which are disallowed include the deductions for partially tax-exempt interest and for dividends received.

(3) Certain expense deductions applicable to property, allowed under sections 162 and 167, in excess of the amount of rental income from such property.

Section 545 (b) (6) of the House bill, disallowing the capital carryover for purposes of determining undistributed personal holding company income, has been deleted by your committee. The amendment conforms to existing law.

Section 546. Income not placed on annual basis

This section is identical with section 546 of the House bill. It corresponds to section 505 (e) of present law and provides that, in computing the personal holding company tax, income shall not be placed on an annual basis where a return for a short taxable year is filed.

Section 547. Deduction for deficiency dividends

This section, which corresponds to section 506 of existing law and is substantially the same as section 547 of the House bill, has been completely revised and rearranged for clarity. This section allows the elimination by a corporation of its personal holding company tax liability of a prior year by making a special distribution of dividends.

Subsection (a) provides that where a determination establishes liability for personal holding company tax for any taxable year, a taxpayer shall be entitled, under certain conditions, to a deduction for the amount of deficiency dividends for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such tax.

Subsection (b) provides that, if the allowance of a deficiency dividend deduction results in an overpayment of personal holding company tax for any taxable year, credit or refund with respect to such overpayment shall be made as if on the date of the determination 2 years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates. No interest is allowed on a credit or refund arising from the application of section 547.

Subsection (c) expands the definition of "determination" as contained in existing law to include, in addition to a decision by a court of competent jurisdiction which has become final or a closing agreement made under section 3760, an informal agreement signed by the Secretary or his delegate and the taxpayer relating to the liability of such taxpayer for personal holding company tax.

Deficiency dividends are defined in subsection (d), as revised, as the amount of dividends paid by the corporation, on or after the date of the determination and prior to filing claim for the deficiency dividend deduction, which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. The provision of the House bill referring to dividends paid by an acquiring corporation has been deleted in section 547, and an appropriate insertion made in section 381 of your committee's bill.

For purposes of this section the dividends must be distributed within 90 days after the determination and the claim for the deficiency dividend deduction must be filed within 120 days after the determination (subsec. (e)). Such deduction is allowed as of the date the claim for the deficiency is filed (subsec. (b)).

Subsection (f) provides for the suspension of the running of the statute of limitations and stay of collection for a period of 2 years in respect of the deficiency and all interest, additional amounts, or assessable penalties arising as a result of any claim filed under subsection (c).

Subsection (g) provides that no deficiency dividend deduction shall be allowed if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to a willful failure to file an income-tax return within the time prescribed by law or prescribed by the Secretary or his delegate pursuant to the law.

Subsection (h) provides that subsection (a) through (f), inclusive, shall be applicable only with respect to determinations made more than 90 days after the date of enactment of this title. Where the deficiency is asserted for a taxable year beginning before January 1, 1954, the term "deficiency dividends" includes only amounts which would have been includible in the computation of the basic surtax credit for such year under the 1939 Code.

Part III—Foreign Personal Holding Companies

IN GENERAL

Sections 551–557, corresponding to sections 331–340 of existing law, contains rules with respect to the inclusion in a United States shareholder's income of his proportionate share of the income of a foreign personal holding company.

Section 551. Foreign personal holding company income taxed to United States shareholders

This section, which corresponds to section 337 of existing law and is identical to section 551 of the House bill, provides that the undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of United States shareholders.

Subsections (a), (b), (d), (e), and (g) are substantially the same as present law. Subsection (c) has been rewritten to accord with other changes in the bill, but no substantive change has been made.

Subsection (f), relating to the basis of stock in the hands of the shareholders, is substantially the same as present law except the period of time therein designated has been reduced from 7 years to 6 years to accord with amendments to the administrative provisions of the revised code.

Section 552. Definition of foreign personal holding company

This section is identical with section 552 of the House bill.

This section is substantially the same as section 331 of existing law, which provides the definition of a foreign personal holding company.

Section 553. Foreign personal holding company income

This section is identical with section 553 of the House bill.

This section, corresponding to section 332 of existing law, defines foreign personal holding company income. The section has been simplified by stating that foreign personal holding company income is to be determined in the same manner as is provided in section 543 with respect to personal holding company income, except that all interest, whether or not treated as rent, and all royalties, whether or not mineral, oil or gas royalties, constitute foreign personal holding company income.

Section 554. Stock ownership

This section is identical with section 554 of the House bill.

This section, corresponding to section 333 of existing law, provides that the rules contained in section 544, relating to rules for determining stock ownership of a personal holding company, shall be applicable in determining stock ownership of a foreign personal holding company.

Section 555. Gross income of foreign personal holding companies

This section is identical with section 555 of the House bill.

This section, corresponding to section 334 of existing law, defines "gross income" in the case of a foreign personal holding company as if the foreign corporation were a domestic corporation which is a personal holding company.

Section 556. Undistributed foreign personal holding company income

This section corresponds to section 556 of the House bill except for a technical amendment to section 556 (b) (2).

Subsection (a) defines "undistributed foreign personal holding company income", i. e., the amount to be included in the gross income of the corporation's shareholders, and basically is a combination of the adjustments required in computing "supplement P net income" and "undistributed supplement P net income" of present law. The undistributed foreign personal holding company income is the taxable income of a foreign personal holding company after applying the adjustments provided in subsection (b), minus the dividends paid deduction as defined in section 561.

Subsection (b) provides that the same adjustments be made to taxable income as is required in computing supplement P net income under existing law, except that the net operating loss deduction for the preceding taxable year is allowed as an adjustment to taxable income rather than as a factor in determining the dividends paid credit under existing law. Also the deduction for taxes and charitable contributions are amended to conform with the changes made with respect to such deductions in the case of a personal holding company.

An amendment by your committee to section 556 (b) (2) clarifies the application of the charitable limitation and conforms to existing law with respect to the treatment, for purposes of the charitable contribution deduction, of deductions disallowed under paragraphs (5) and (6) of subsection (b).

Section 557. Income not placed on annual basis

This section is identical with section 557 of the House bill which corresponds to section 336 (d) of present law and provides that in computing the undistributed foreign personal holding company income under section 556, section 443 (b), relating to computation of tax on change of annual accounting period, shall not be applicable.

PART IV—DEDUCTION FOR DIVIDENDS PAID

IN GENERAL

Sections 561–564, corresponding in part to section 27 of existing law, provides rules for the computation of the dividends paid deduction. The provisions have been rearranged and revised in the interest of simplification. The net operating loss credit and the credit for bank affiliates, allowable under present law in the computation of the dividends paid credit, are allowed under the bill as adjustments to taxable income.

Your committee has amended the House provisions to restore consent dividends as an element of the dividends paid deduction.

Section 561. Definition of deduction for dividends paid

This section, corresponding to section 27 (a) of existing law, is substantially the same as section 561 of the House bill except for the allowance of consent dividends as a part of the dividends paid deduction.

Subsection (a), as revised, provides that the dividends paid deduction shall consist of (1) the dividends paid during the taxable year, (2) the consent dividends for the taxable year, and (3) in the case of a personal holding company, the dividend carryover described in section 564.

Subsection (b), as revised, provides that the rules of section 562 (relating to the eligibility of dividends for the dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall apply in determining the dividends paid deduction. Such rules are applicable to consent dividends as well as to distributions in money or other property.

Section 562. Rules applicable in determining dividends eligible for dividends paid deduction

This section conforms to section 562 of the House bill except for a clerical amendment.

Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). The requirements of sections 27 (d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312, and accordingly are not restated in section 562.

Subsection (b), corresponding to section 27 (g) of existing law, provides that distributions during the taxable year in liquidation of a corporation which are properly chargeable to earnings and profits accumulated after February 28, 1913, are treated as dividend distributions. In addition, a corporation in the process of a complete liquidation occurring within a 24-month period shall treat any distribution within such period made pursuant to the plan of liquidation as a dividend for purposes of computing the dividends paid deduction, to the extent of the current earnings and profits (computed without regard to capital losses).

Subsection (c), corresponding to section 27 (h) of existing law, provides the rule to be applied in the case of preferential dividends.

Subsection (d) is new and provides that, where a personal holding company files a consolidated return with other members of an affiliated group under section 542 (b) but is required to file a separate personal holding company schedule, then a distribution of a dividend by such company to another member of the affiliated group shall be considered as a dividend for purposes of computing the dividends paid deduction if such distribution would constitute a taxable dividend to a recipient not a member of the affiliated group.

Section 563. Rules relating to dividends paid after close of taxable year

This section conforms to section 563 of the House bill except for a clarifying amendment to section 563 (c).

Subsection (a) is new and provides that, in computing the accumulated earnings tax under section 531, a corporation shall include in the computation of its dividends paid deduction the amount of dividends paid after the close of a taxable year and on or before the 15th day of the third month following the close of such taxable year.

Subsection (b) is the same as section 504 (c) of existing law.

Subsection (c) provides that, where a distribution is made after the close of the taxable year, such distribution shall be considered to have been made on the last day of such taxable year. Under this rule, the taxability of such a distribution as a dividend will be determined according to the earnings and profits of the corporation on the last day of its taxable year.

Section 564. Dividend carryover

This section conforms to section 564 of the House bill, except for a technical amendment to subsection (c), relating to cases to which the 1939 Code provisions apply.

This section, corresponding to section 27 (c) of existing law, provides for the computation of the dividend carryover; i. e., the excess of dividends paid in the 2 preceding years over the income for such years. The section has been rewritten for clarity and simplification. The principal changes have been the elimination of the net operating loss credit and the bank affiliate credit from the computation of the carryover. In addition, only the dividends paid in the 2 preceding taxable years enter into the computation of the dividend carryover.

In a case where either the first or second preceding taxable year began before the taxpayer's first taxable year under this subchapter, subsection (c), as revised by your committee, provides that the amount of the dividend carryover to taxable years to which this subtitle applies shall be determined under the provisions of the 1939 Code.

Section 565. Consent dividends

This section, for which there is no corresponding provisions in the House bill, provides a method whereby a corporation may obtain a dividends paid deduction without the necessity of making an actual distribution. The section corresponds, in general, to section 28 of the 1939 Code, relating to consent dividends.

Subsection (a) provides the general rule with respect to consent dividends. It states that if any shareholder who owns consent stock in a corporation on the last day of the taxable year of such corporation agrees, in a consent filed with a return of such corporation, to treat as a dividend an amount specified in such consent, then the amount so specified shall constitute a consent dividend for purposes of section 561 (relating to the deduction for dividends paid). The making and filing of such consents is to be in accordance with regulations prescribed by the Secretary or his delegate.

Subsection (b), however, provides certain limitations on the extent to which the amount specified in a consent may constitute a consent dividend. An amount specified in a consent will not constitute a consent dividend to the extent that, if the amount specified in the consent were distributed by the corporation in money, such a distribution would not constitute a dividend within the meaning of section 316. Moreover, a consent dividend does not include an amount which, if distributed in money, would constitute, or be part of, a distribution disqualified as a preferential dividend under section 562 (c). Where all or any part of the amount specified in the consent does not qualify as a consent dividend, the amount so disqualified shall be disregarded for all tax purposes.

Under subsection (c) the amount of the consent dividend shall be considered, for all purposes of this title, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be taxed to the shareholder as a dividend. The shareholder will be entitled to the dividends received credit under section 34, the exclusion under section 116 or the dividends received deduction under section 243, with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus taxed to him as a dividend and which he is considered as having contributed to the corporation as paid-in capital. The amount of the consent dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend had been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

Subsection (d) provides a rule applicable where a distribution is made in part in consent dividends and in part in money or other property. This subsection provides that, for purposes of applying the income tax title, the entire amount specified in the consents and the amount of such money or other property shall be considered together. Thus, if consents are filed by some of the shareholders and cash is distributed to other shareholders who are unwilling to sign consents, the total amount of the cash and the amounts specified in the consents will be viewed as a single distribution to determine the tax effects of such distribution. For example, the total of such amounts must be considered to determine whether the distribution (including the amount specified in the consents) is a preferential distribution and whether any part of such distribution would not be a dividend if the total amounts specified in the consent were distributed in cash.

Subsection (e) provides that where a consent dividend would, if paid in money, be subject to the withholding provisions of section 1441 or 1442, the consent dividend section shall not apply unless the consents are accompanied by money, or other medium of payment, equal to the amount that would be required to be withheld if the consent dividend had been paid in money. The amount accompanying the consent shall be credited against the tax imposed on the shareholder.

Subsection (f) contains the definition of consent stock and preferred dividends. Consent stock is defined as the class or classes of stock entitled, after the payment of preferred dividends, to share in the distribution (other than incomplete or partial liquidation) within the taxable year of all of the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution. Preferred dividends are defined as a distribution (other than incomplete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than incomplete or partial liquidation) of earnings and profits may be made within the taxable year. These definitions correspond to provisions of existing law.

SUBCHAPTER H—BANKING INSTITUTIONS

Part I—Rules of General Application to Banking Institutions

The provisions of this part containing sections 581 to 584, inclusive, conform to the corresponding provisions of the House bill.

Section 581. Definition of bank

This section is identical with section 104 (a) of the 1939 Code. No substantive changes have been made.

Section 582. Bad debt and loss deduction with respect to securities held by banks

This section is identical with section 582 of the House bill.

Subsection (a) of this section is derived from section 23 (k) of the 1939 Code.

Subsection (b) is applicable to worthless stock in an affiliated bank. The subsection provides that for purposes of section 165 (g) (1) (worthless securities) where the taxpayer is a bank and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset. The effect of this section is that the loss on the security of the affiliated bank will be deductible under section 165 (a), which provides for the deduction of losses sustained during the taxable year and not compensated for by insurance or otherwise.

Subsection (c) corresponds to section 117 (i) of the 1939 Code. No substantive changes have been made.

Section 583. Deductions of dividends paid on certain preferred stock

This section is identical with section 583 of the House bill and conforms to section 121 of the 1939 Code.

Section 584. Common trust funds

This section corresponds to section 584 of the House bill except that subsection (f) of the House bill has been stricken. It also corresponds to section 169 of the 1939 Code, except that subsection (h) is derived from section 170. The rule for treatment of partially tax exempt interest, as stated in subsection (c) (2) has been made applicable to dividends to which section 34 (relating to the credit against tax provided for dividends received by individuals) and section 116 (relating to exclusions from dividends of certain income received) apply.

Part II—Mutual Savings Banks, etc.

The provisions of this part containing sections 591 to 594, inclusive, are identical with the corresponding provisions of the House bill.

Section 591. Deduction for dividends paid on deposits

This section corresponds to section 23 (r) of the 1939 Code.

Section 592. Deduction for repayment of certain loans

This section corresponds to section 23 (dd) of the 1939 Code.

Section 593. Additions to reserve for bad debts

This section is derived from section 23 (k) of the 1939 Code.

Section 594. Alternative tax for mutual savings banks conducting life-insurance business

This section corresponds to section 110 of the 1939 Code.

Part III—Bank Affiliates

Section 601. Special deduction for bank affiliates

This section is identical with section 601 of the bill as passed by the House and corresponds to section 26 (d) of the 1939 Code.

SUBCHAPTER I—NATURAL RESOURCES

Part I—Deductions

Section 611. Allowance of deduction for depletion

This section corresponds to section 611 of the bill as passed by the House, and is derived from section 23 (m) of the 1939 Code. Section 611 of the House bill made certain clerical changes in existing law, but made no substantive change other than to provide that the term "mines" includes deposits of waste or residue of mines, the extraction of ores or minerals from which is treated as mining under section 613 (c). The effect of this provision of the House bill is to extend allowances for depletion to the extraction of ores or minerals from waste or residue of prior mining. Under this section of the bill a waste pile is not considered, for purposes of the deduction for depletion, to be a separate property but a part of the property from which it was extracted. Thus, where a mineowner is engaged in the mining and sale of ores or minerals from original mine workings along with ores or minerals produced by him from waste therefrom, the gross income from both shall be aggregated in determining the gross income from the property. Likewise, the output from waste shall be combined with the output of original mine workings in determining whether cost depletion or depletion based on percentage of income is applicable.

Your committee has added to section 611 of the House bill a new paragraph to the effect that in the case of an estate, the depletion deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each. Your committee has also added to section 611 a new subsection which contains a cross-reference to section 167 for other rules applicable to depreciation of improvements. This cross-reference makes it clear that the rules of section 167 are also applicable to depreciable property described in section 611.

Section 612. Basis for cost depletion

This section corresponds to section 612 of the bill as passed by the House, and is the same as section 114 (b) (1) of the 1939 Code, except for certain minor clerical changes. There bas been no substantive change. Your committee made a clarifying amendment by changing the reference to "this subtitle" rather than "section 613."

Section 613. Percentage depletion

This section corresponds to section 613 of the bill as passed by the House. Your committee has made a number of substantive changes.

Section 613 (a) of the House bill is derived from portions of the 1939 Code and contains nothing new in substance, except for the last sentence which provides a special rule for the computation of cost depletion in cases where there has been an aggregation of mineral interests for computation of percentage depletion under section 614. Because your committee proposes that any aggregation be permitted for purposes of cost as well as percentage depletion, this sentence is no longer necessary and has therefore been eliminated by your committee. Otherwise, section 613 (a) is the same as under the House bill. It provides that in the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property, excluding from such gross income an amount equal to any rents or royalties (payee's share of depletable income) paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to section 613.

Existing law provides that the allowance for depletion shall not exceed 50 percent of the taxpayer's "net income" from the property (computed without allowance for depletion). The phrase "taxable income" has been used in section 613 (a) because the term "net income" has been eliminated from the new code and "taxable income" substituted therefor. As used in section 613, the term "taxable income from the property" means the same as "net income from the property" in existing section 114 (b) (3), (4) (A), and no substantive change is intended by the change in language. In computing taxable income from the property it is intended that there be taken into account all deductible items (other than depletion) including such items as administrative and financial overhead expenditures and taxes which, under sound accounting principles, are attributable to extraction or processes treated as mining.

Section 613 (b) is derived from sections 114 (b) (3) and 114 (b) (4) (A) of the 1939 Code and contains the rates of percentage depletion. Neither the House bill nor your committee has made any change in existing law with respect to the rates of percentage depletion in the case of oil and gas wells and sulfur. With respect to other minerals, the House bill provides a 15 percent rate for the following: Ball clay, sagger clay, china clay, chemical grade limestone, metallurgical grade limestone, metal mines, rock asphalt, slate (5 percent under existing law), and vermiculite. A 10 percent rate of depletion is applied to asbestos, brucite, coal, lignite, perlite, and wollastonite, as provided in existing law. The House bill applies a 5 percent rate to all minerals specifically entitled to that rate under existing law (except slate) and also to peat and all mollusk shells (including clam shells and oyster shells).

Your committee has amended section 613 (b) (2) of the House bill in several respects. The rate of percentage depletion for uranium is increased from 15 percent to 23 percent. Also your committee has added a new subparagraph (B) under the 23 percent category which provides that the following minerals shall be entitled to a 23 percent rate if mined from deposits in the United States: anorthosite (to the extent alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, beryl, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, quartz crystal (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and platinum group metals, tantalum, tin, tungsten, vanadium, thorium, and zinc.

In section 613 (b) (3) your committee has added bentonite to the list of minerals specifically named in the 15 percent category. However, your committee has eliminated chemical grade limestone, metallurgical grade limestone, and slate from the minerals specifically named at 15 percent. These minerals will continue to be entitled to the 15 percent rate, however, unless used for the purposes (road material, riprap, etc.) specified in section 613 (b) (6), in which case the rate will be 5 percent. Under section 613 (b) (3) as amended by your committee, a 15 percent rate of percentage depletion will apply to ball clay, bentonite, china clay, sagger clay, metal mines (if par. (2) (B) does not apply), rock asphalt, and vermiculite.

In section 613 (b) (4) your committee has increased the rate of percentage depletion for sodium chloride from 5 percent to 10 percent. The other minerals named in section 614 (b) (4) which are entitled to a 10 percent rate of depletion, regardless of the purposes for which used, are asbestos (if par. (2) (B) does not apply), brucite, coal, lignite, perlite, and wollastonite.

In section 613 (b) (5) your committee has eliminated granite and marble from the minerals specifically named in the 5 percent category. The effect of this change is to extend to these minerals a 15 percent rate of percentage depletion, except where such minerals are used for the purposes (road material, riprap, etc.) specified in section 613 (b) (6), in which case the rate will be 5 percent. Your committee has also amended section 613 (b) (5) to provide that stone (unless used or sold for use by the mine owner or operator as dimension stone or ornamental stone) will be entitled to depletion at the 5 percent rate.

Section 613 (b) (6) of the House bill applies a 15 percent rate to all other minerals, except that the rate shall be 5 percent for any such minerals when they are used or sold for use as riprap, ballast, road material, rubble, concrete aggregates, dimension stone, ornamental stone, or for similar purposes. Your committee accepted the principle in the House bill that all minerals within the scope of paragraph (6) (whether or not specifically mentioned in that paragraph) will be subject to a use test. However, your committee has amended this section by eliminating dimension stone and ornamental stone from the "use test" of subsection (b) (6), so that use of a mineral for these purposes will not reduce the rate from 15 percent to 5 percent. Furthermore, for purposes of clarification, your committee has amended section 613 (b) (6) by parenthetically enumerating, after the term "all other minerals," a list of minerals, including some which are specifically named in present law, but which are not otherwise specifically provided for in section 613 (b). This list includes stone used, or sold for use, by the mine owner or operator as dimension stone or ornamental stone. "Dimension stone" means blocks and slabs of natural stone cut to definite shapes and sizes, such as building stone (excluding rubble), monumental stone, paving blocks, curbing and flagging. In addition, your committee has redefined the term "all other minerals" as not including soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or from similar inexhaustible sources. A technical change has also been made so as to make clear that the "use test" of section 613 (b) (6) is to apply when the mineral is used or sold for use by the mine owner or operator for the specified uses.

The term "all other minerals" is not limited to those minerals parenthetically named in section 613 (b) (6) and includes minerals not otherwise specifically provided for in section 613 (b), including some minerals not entitled to percentage depletion under existing law as well as many that are. The term includes, for example, gypsum, kyanite (if paragraph (2) (B) does not apply), novaculite, natural mineral pigments, quartz sand and quartz pebbles, and slate. Thus the 15 percent rate would be applicable to quartz sand and quartz pebbles when used or sold for purposes dependent on the chemical or refractory properties of such minerals and slate when used or sold for granules for roofing, or in the manufacture of phonograph records.

Section 613 (c) of the bill as passed by the House corresponds to section 114 (b) (4) (B) of the 1939 Code, under which the rate of percentage depletion is applied to "gross income from the property," and that term is defined to mean, in the case of a property other than an oil or gas well, the gross income from "mining." The term "mining" in existing law is defined to mean not merely the extraction of ores or minerals from the ground but also certain "ordinary treatment processes" applied by mine owners or operators and certain specified transportation. Existing law provides four separate categories of specific processes which are considered to be included within the term "ordinary treatment processes." The House bill amended existing law with respect to sulfur to indicate that the specified processes apply only to the recovery of sulfur by the Frasch process. In cases where sulfur is recovered by processes other than the Frasch process, such other processes will be allowed or disallowed as "ordinary treatment processes" in accordance with the general provisions of section 613 (c). Your committee has amended section 613 (c) (4) (A) to provide that in the case of coal dust allaying and treating to prevent freezing are considered ordinary treatment processes. The House bill amended existing law specifically to provide that the term "ordinary treatment processes" includes the pulverization of talc and the burning of magnesite. Your committee has added to this list "the sintering and nodulizing of phosphate rock." In the case of uranium the gross income from the property for purposes of applying the percentage depletion allowance will be determined by reducing the sale price of the ore by the net transportation cost of the taxpayer. For this purpose, the net transportation cost means the taxpayer's transportation cost reduced by the hauling allowance allowed by the Atomic Energy Commission.

Section 613 (c) (3) of the House bill extended depletion to deposits of waste or residue of prior mining by adding a provision that the term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. Under the House bill this provision is not applicable to any such extraction of the mineral or ore by the purchaser of such waste or residue or of the rights to extract ores or minerals therefrom. For purposes of section 613 (c) (3), the word "purchaser" does not apply to a person who acquires the whole mine property, including such waste or residue, in a tax-free exchange (e. g., through a tax-free corporate reorganization) from a person who was entitled to depletion upon such waste or residue. Likewise, the term "purchaser" does not apply to a lessee, upon the renewal of a mineral lease, if such lessee was entitled to depletion in respect of the waste or residue prior to the renewal of such lease. On the other hand, the term "purchaser" includes a person who acquires such waste or residue in a taxable transaction, even though such waste or residue may be acquired merely as an incidental part of the whole mine property. Under section 613 (c) (3), it is immaterial whether the waste or residue results from the process of removal from the ground or from the application of ordinary treatment processes. However, section 613 (c) (3) does not apply to waste or residue which results from processes which are not considered to be ordinary treatment processes.

Your committee's action on this section applies only to 1954 and future years. No inference can be drawn from the reclassification of certain minerals and other actions as to the meaning of present law.

Section 614. Definition of property

This section corresponds to section 614 of the bill as passed by the House, and has no counterpart in the 1939 Code. It provides a statutory definition of the term "property" for purposes of computing the depletion allowance in the case of mines, wells, and other natural deposits. Present law contemplates that the depletion allowance shall be computed by properties, but provides no definition of a "property."

Section 614 (a) is identical with the corresponding provision as passed by the House. It provides a general rule which states that for the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. For purposes of this definition, tracts or parcels may be separated by conveyancing, as well as geographically.

Subsection (b) prescribes a special rule which is applicable only in the case of operating mineral interests (as defined in subsec. (b) (3)). Your committee has made several amendments to this subsection as passed by the House. The House bill provided that if a taxpayer owns two or more separate operating mineral interests which constitute part or all of an operating unit, he may elect (but only for the purpose of computing the allowance for percentage depletion) to form one aggregation of any two or more of such interests, and to treat such aggregation as one property. Your committee has amended section 614 (b) (1) to provide that an aggregation adopted under this section shall be effective for all purposes of the income tax subtitle, and is not limited to the computation of percentage depletion, as under the House bill. The effect of this amendment is to make the definition of property consistent so as to be applicable to the computation of both cost and percentage depletion, and to the computation of gain or loss upon a sale or exchange.

The adoption of a uniform definition of property, as described in the preceding paragraph, makes possible the elimination of paragraph (4) of section 614 (b), and the last sentence of section 613 (a) as passed by the House. The last sentence of section 613 (a) of the House bill provided a special rule for the computation of cost depletion in cases where there had been an aggregation (under sec. 614 (b)) of mineral interests only for percentage depletion. Since under section 614 (b) as amended by your committee the definition of property is the same for both cost and percentage depletion, this sentence is no longer necessary. Paragraph (4) of section 614 (b) required the apportionment of the aggregate depletion allowance among the mineral interests aggregated for the purpose of determining the adjustment to basis of each such mineral interest. This paragraph has been eliminated since under your committee's provision the various mineral interests in the aggregation lose their separate identities upon the taxpayer's adoption of the aggregation.

In all other respects, section 614 (b) is substantially the same as passed by the House. It provides that a taxpayer shall be deemed to have elected to treat as a separate property each interest owned by him in the operating unit which he has not elected to include within the aggregation. Separate operating mineral interests which constitute part or all of an operating unit may be aggregated whether or not they are included in a single tract or parcel of land and whether or not they are included in contiguous tracts or parcels. A taxpayer may not elect to form more than one aggregation of operating mineral interests within any one operating unit.

The term "operating unit" is susceptible to a reasonable interpretation. In general, the term contemplates an aggregation only of interests which may conveniently and economically be operated together as a single working unit. Thus, interests which are geographically widespread may not be considered parts of the same operating unit merely because one set of accounting records is maintained by the taxpayer, or merely because the products of such interests are processed at the same treatment plant.

The term "operating mineral interest" is defined in paragraph (3) of subsection (b) as including only interests in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for the purpose of computing the 50-percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage.

Therefore, subsection (b) does not permit the aggregation of any type of royalty interest (or similar interest).

Paragraph (2) of section 614 (b) of the House bill provides that the election provided in paragraph (1) shall be made for each operating mineral interest (in accordance with regulations prescribed by the Secretary or his delegate), not later than the time prescribed by this subtitle for filing the return (including extensions thereof) for whichever of the following taxable years is the later: (1) the first taxable year beginning after December 31, 1953, or (2) the first taxable year in which any expenditure for exploration, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest. Since the time for filing the return is not prescribed in subtitle A, your committee has made a clerical amendment to this paragraph by providing that the election shall be made not later than the time prescribed by law for filing the return for the described taxable years. For purposes of this paragraph, the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest. An election under subsection (b) shall be binding upon the taxpayer for all subsequent taxable years, except that the Secretary or his delegate may consent to a different treatment of the interests in respect of which the election has been made. For purposes of this section, a change in tax consequences alone will not justify a treatment different from that elected by the taxpayer. However, consent to a new election would be appropriate in case the operating unit changes so that part of the aggregation is no longer in the operating unit.

Your committee has added a new subsection (c) which provides a special rule as to nonoperating mineral interests. It provides that if a taxpayer owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, the Secretary or his delegate may, on showing of undue hardship, permit the taxpayer to treat (for all purposes of this subtitle) all such mineral interests as one property. If such permission is granted for any taxable year, the taxpayer shall treat such interests as one property for all subsequent taxable years, unless the Secretary or his delegate consents to a different treatment. For purposes of this subsection, undue hardship shall not be deemed to exist by reason of mere tax disadvantage. Nonoperating mineral interests are defined for purposes of this subsection as interests which are not operating mineral interests within the meaning of section 614 (b) (3), and thus includes royalty interests. In no case may a nonoperating interest be aggregated with an operating interest.

In cases where there has been an aggregation under subsection (b) or (c), if the taxpayer subsequently sells or otherwise disposes of a part of the aggregation, the adjusted basis of the aggregation shall be reasonably apportioned in order to determine the adjusted basis of the part disposed of.

The operation of the provisions of this section may be illustrated by the following examples, in which it is assumed that each taxpayer is on a calendar-year basis.

(1) A taxpayer owns one tract of land under which lie three separate and distinct seams of coal. The taxpayer is considered

under section 614 (a) to own three separate mineral interests. However, if the taxpayer mines coal from all three seams, and maintains only one operating unit with respect thereto, he may elect, under section 614 (b) (1), to aggregate the three operating mineral interests, and to treat such aggregation as one property for all purposes of this subtitle.

(2) A taxpayer conducts mining operations on eight separate tracts of land, all of which he acquired and operated as a single mine prior to December 31, 1953. Each tract of land contains only one mineral deposit and the taxpayer is considered to own eight separate operating mineral interests under section 614 (a). The taxpayer may make, with respect to each interest, an election under subsection (b) (1) not later than the time prescribed for filing the return for the taxable year beginning January 1, 1954. If it is assumed that the taxpayer elects to form one aggregation of five of the separate operating mineral interests owned by him in the operating unit, and to treat such aggregation as one property, he must treat each of the other three operating mineral interests as separate properties. Thereafter, the taxpayer will compute depletion for four properties. If the taxpayer subsequently desires to include in the aggregation any or all of the separate nonaggregated interests it will be necessary for him to obtain the consent of the Secretary or his delegate to such different treatment. The same consent is required if the taxpayer desires to withdraw one of the aggregated mineral interests from the aggregation and to compute depletion with respect to such interest separately. If, in 1955, the taxpayer should extend his operating unit so as to include an additional interest acquired and developed by him in that year, he may elect on or before the date prescribed for the filing of the return for 1955, either to treat this interest as a part of the aggregation, or to treat it as a separate property. In no case will he be entitled to aggregate such subsequently acquired interest with any of the nonaggregated interests in the operating unit.

(3) A taxpayer operates mines A and B as two separate operating units and attempts to aggregate an interest forming a part of mine A with an interest constituting a part of mine B. Such an election is not permitted, because section 614 (b) (1) requires that the interests aggregated must all belong to the same operating unit.

(4) A taxpayer owns a large tract of land under which lies one deposit of ore. The taxpayer operates a single mine near the center of this tract and leases to another operator the mineral rights with respect to an outlying area retaining a royalty interest therein. It is assumed that the costs of operation of the outlying tract are not required to be taken into account by the taxpayer. While the taxpayer is considered as owning two separate properties, they may not be aggregated since the interest in the outlying tract is a royalty interest, which does not constitute an operating interest, as defined in section 614 (b) (3).

Section 615. Exploration expenditures

This section, which is derived from section 23 (ff) of the 1939 Code, corresponds to section 615 of the House bill. Under existing law, the taxpayer may deduct in the current year expenditures for mine exploration not in excess of $75,000, paid or incurred by him in the taxable year, or he may elect to defer any part of such deductible expenditures and deduct such deferred expenditures ratably as the ores or minerals benefited are sold. The deduction or election may not be taken or exercised if in any 4 preceding years, not necessarily consecutive, the taxpayer (or any individual or corporation who has transferred a mineral property to the taxpayer under circumstances which require the application of certain basis provisions of existing law) has taken the deduction or exercised the election to defer. These basis provisions were modified in the House bill, and conforming changes in section 615 were made accordingly.

Since your committee has made additional changes in the basis provisions of the House bill, conforming amendments have been made in this section.

As under existing law, the benefits of a prior election are not available to a purchaser of a mineral property, and in such cases any deduction taken or election exercised by the vendor may be disregarded by the taxpayer in applying the 4-year limitation.

Your committee has increased the amount of exploration expenditures which may be deducted or deferred under section 615 from $75,000, as provided in existing law and the House bill, to $100,000.

Section 616. Development expenditures

This section is identical with section 616 of the bill as passed by the House and is derived from section 23 (cc) of the 1939 Code. Except for conforming clerical changes, no revision is made in existing law.

PART II—EXCLUSIONS FROM GROSS INCOME

Section 621. Payments to encourage exploration, development, and mining for defense purposes

This section, which is identical with section 621 of the House bill, corresponds to section 22 (b) (15) of the 1939 Code. No substantive changes in existing law have been made.

PART III—SALES AND EXCHANGES

Section 631. Gain or loss in the case of timber, coal, or iron ore

This section corresponds to section 631 of the bill as passed by the House. Your committee has made substantive changes.

Section 631 (a) of the House bill corresponds to section 117 (k) (1) of the 1939 Code, which provides that a taxpayer who owns, or has a contract right to cut, timber may elect upon his return to treat the cutting of such timber as a sale or exchange thereof. Section 631 (a) of the House bill amended existing law to provide that (in case the taxpayer elects to make this subsection applicable) certain expenditures of the taxpayer allocable to the timber cut during the year, and disallowed as deductions under section 272 (a), shall be added to the adjusted basis of the timber cut for the purpose of determining the gain or loss to be realized on account of such cutting of timber. Section 272 (a) has been eliminated from the bill by your committee, and the reference to section 272 (a) in section 631 (a) has accordingly been omitted. The effect of this amendment to the House bill is to continue section 117 (k) (1) of the 1939 Code.

Your committee has amended section 631 (a) of the House bill to provide that for purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

Section 631 (b) of the House bill made certain amendments to section 117 (k) (2) of the 1939 Code, which provides that in the case of the disposal of timber or coal, held for more than 6 months before such disposal, by the owner thereof under a contract whereby the owner retains an economic interest in such timber or coal, the difference between the amount received for such timber or coal 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 or coal. Section 631 (b) of the House bill extends the benefits of section 117 (k) (2) of the 1939 Code, with respect to coal, to any person who owns an economic interest in the coal in place, including a sublessor.

This section of the House bill also amended existing law by providing that in determining the gain or loss realized from the disposal of coal or timber, the expenditures of the owner for which deductions are disallowed under section 272 (b), attributable to the making and administering of the contract under which the coal or timber is disposed of, and attributable to the preservation of the economic interest which such owner retains under the contract, shall be added to the adjusted depletion basis of the coal or timber disposed of.

Your committee has rearranged section 631 (b) of the House bill by dividing it into two subsections—subsection (b), which is applicable to timber, and subsection (c), which is applicable to coal and to iron ore from deposits in the United States. Section 117 (k) (2) of the 1939 Code has not previously applied to iron ore.

Subsection (b) in effect continues the treatment of section 117 (k) (2) of the 1939 Code with respect to the disposal of timber with a retained economic interest, except that your committee has added a new provision to the effect that the date of disposal of such timber shall be deemed to be the date such timber is cut or if payment is made to the owner before the cutting, the owner may elect to treat the date of payment as the date of disposal, rather than the date of the royalty contract, as was held in *Springfield Plywood Corp.* (15 T. C. 697). The election would be appropriate in a case where the owner receives an annual minmium royalty payment that entitles the lessee to cut the timber in a future year, and the timber is actually cut pursuant to the right so acquired.

In addition a provision has been added defining the term "owner" as any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber.

As noted above, section 631 (b) of the House bill provided that in determining gain or loss from the disposal of timber, the expenditures of the owner for which deductions are disallowed under section 272 (b) should be added to the adjusted basis of the timber disposed of. Your committee has omitted this provision from section 613 (b) in view of the fact that section 272 of the House bill has been amended so as to make it inapplicable to timber. The effect of this change is to restore the rule of existing law with respect to such expenditures.

Subsection (c) of section 631 as amended by your committee corresponds to section 117 (k) (2) of the 1939 Code with respect to coal, and extends the benefits of section 117 (k) (2) to iron ore from deposits in the United States. With this one exception, no substantive change has been made in the treatment provided under the House bill. Subsection (c) provides that in the case of the disposal of coal (including lignite), or iron ore from deposits in the United States, 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 or iron ore, the difference between the amount realized from the disposal of such coal or iron ore 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 or iron ore. For a description of the expenditures disallowed as deductions by section 272, see the corresponding section of this report.

Section 631 (c) continues the provision of the House bill that (in the case of coal) the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor, and extends it to iron ore from deposits within the United States. An owner of coal or iron ore entitled to the benefits of section 631 (c) shall not, of course, be entitled to the allowance for percentage depletion in section 613, with respect to such coal or iron ore. Under section 631 (c) the rule of existing law that the date of disposal of coal shall be deemed to be the date such coal is mined is extended to iron ore to which this section applies.

Section 632. Sale of oil or gas properties

This section is identical with section 632 of the House bill, which corresponds to section 105 of the 1939 Code. Except for conforming clerical changes no revision is made in existing law.

SUBCHAPTER J—ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

Part I—Estates, Trusts, and Beneficiaries

This subchapter is divided into two parts. Part I deals with the taxation of income of trusts and estates and their beneficiaries. Part II deals with the taxation of income received in respect of decedents. In general, the statutory provisions of this subchapter correspond to supplement E and section 126 of the 1939 Code; however, the provisions dealing with employees' trusts (sec. 165, I. R. C.) and common trust funds (sec. 169, I. R. C.) are excluded from this subchapter and treated in subchapter F (Exempt Organizations) and subchapter H (Banking Institutions) respectively.

SUBPART A—GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

Section 641. Imposition of tax

This section is identical with section 641 of the House bill.

This section corresponds to section 161 of the 1939 Code and provides that the normal and surtaxes imposed by chapter I upon individuals shall apply to the taxable income of estates and to the taxable income of any kind of property held in trust.

The several classes of income enumerated in paragraphs (1) through (4) of subsection (a) are carried over from section 161 and are illustrative of estate and trust income dealt with in this subchapter; the classification does not exclude other types of estate and trust income which may fall within the purview of this subchapter. A guardian, whether of an infant or other person, is a fiduciary and, as such, must file a return and pay the tax for his ward; however, the estate of a ward is not a separate taxable entity as is a trust or the estate of a deceased person.

The determination of whether a trust has terminated so that the provisions of this subchapter no longer apply depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. In the case of estates, the period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, legacies, and bequests, whether this period is longer or shorter than the period specified under local law for the settlement of estates. Thus, where an executor, who is also named as trustee under the will, fails to obtain his discharge as executor, the period of administration only continues until the time the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. No distinctions in treatment are made between testamentary trusts and inter vivos trusts. The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it.

Except as noted in the following sections of part I, the taxable income of an estate or trust is computed in the same manner as that of an individual. The tax imposed on the taxable income of the estate or trust must be paid by the fiduciary. However, where the grantor is treated as the substantial owner, under subpart E, of any portion of the property held in trust by reason of his powers of dominion and control over the trust property, as to that portion the gross income therefrom must be included in the gross income of the grantor and there shall be allowed to the grantor the items of statutory deductions and credits attributable to such income to which he would have been entitled had the trust not been created. The same principles apply where a person other than the grantor is treated under subpart E as the substantial owner of any portion of the trust property.

Section 642. Special rules for credits and deductions

This section corresponds to section 642 of the House bill, except for changes in paragraph (3) of subsection (a) and the addition of a new subsection (h).

This section provides special rules for allowing certain deductions to an estate or trust in computing its taxable income and for limiting the credits against tax allowed to an estate or trust.

An estate or trust is allowed a credit against tax for partially tax-exempt interest, included in gross income of the estate or trust, in the same manner as an individual except that the credit is allowed only in respect of so much of the interest as is not includible in the gross income of any beneficiary of the estate or trust. This credit is comparable to that provided in section 163 of the 1939 Code.

Similarly, an estate or trust is allowed the credit against tax provided by section 901 but only in respect of so much of the taxes described in that section as are not properly allocable under that section to the beneficiaries of the estate or trust. This allowance of the foreign tax credit to estates and trusts corresponds to that contained in section 168 of the 1939 Code.

An estate or trust is allowed a credit against tax for any dividends received by the trust or estate (to the extent the credit is allowed under section 34) but the credit is allowed only in respect of so much of the dividends as is not properly allocable to any beneficiary. Thus, if a trust is required to distribute all of its income currently and so distributes to beneficiary A the dividends it receives for the taxable year, beneficiary A, and not the trust, will be entitled to the dividends received credit. Your committee has added a provision for determining the time of receipt of dividends for purposes of sections 34 and 116 where a beneficiary is deemed to have received an allocable portion of dividends under section 652 or 662. For example, if a trust receives quarterly dividends on March 1, June 1, September 1, and December 1, of 1955, and beneficiary A is deemed under section 662 to have received one-third of the dividend income for the calendar year 1955, A will be deemed to have received one-third of each quarterly dividend received by the trust, for purposes of determining the time of receipt, both for the dividend exclusion provided in section 116 and the dividend credit provided in section 34.

Subsection (b) provides that, in lieu of the deduction for personal exemptions allowed to an individual, there shall be allowed the following deductions: Estates, $600; trusts which are required to distribute all of their income currently, $300; all other trusts, $100. This subsection corresponds to section 163 (a) (1) of the 1939 Code but increases the exemption from $100 to $300 in cases of trusts required to distribute all of their income currently. Under section 163 (a) (1) of the 1939 Code the exemption was provided by means of a credit against net income whereas, in conformity with the changes made in section 211 for treatment of personal exemptions, the exemption accorded estates and trusts is a deduction from gross income. To be entitled to the $300 deduction, a trust must be required, by the terms of its governing instrument, to distribute all of its income currently. Income in this context means the amount of income of the trust for its taxable year determined under the terms of its governing instrument and applicable local law. Thus, the deduction may offset small amounts of capital gains which are includible in the gross income of the trust but which, for purposes of the fiduciary's accounting, are allocable to the trust corpus. For purposes of the $300 deduction, it is not material that a trust which is required to distribute all of its income currently also makes a distribution of corpus which disqualifies it in that year from treatment under the provisions of subpart B.

Except as provided in section 681 (relating to prohibited transactions, improper accumulations, and so forth), a trust or estate is allowed an unlimited deduction for charitable contributions and is not subject to the limitation imposed on the charitable contributions of individuals. Subsection (c) thus provides that an estate or trust may deduct any amount of its gross income, without limitation, which pursuant to the terms of the governing instrument is paid or permanently set aside for the purposes and in the manner specified in section 170 (relating to charitable, and so forth, contributions and gifts) or which is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. This provision is comparable to section 162 (a) of the 1939 Code. The deduction under this subsection does not apply in the case of trusts treated under subpart B since a trust which is entitled to a deduction under this subsection is specifically excluded from the provisions of subpart B. If the estate or trust pays, permanently sets aside, or uses any amount of its income for the purposes specified in this subsection and such amount includes any items of trust income not entering into the gross income of the estate or trust, the deduction under this subsection is limited to the gross income so paid, permanently set aside or used. In determining whether such amounts include items of trust income not included in gross income, the amounts shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income entering into the trust income as the total of each class bears to the total of all classes.

The benefit of the net operating loss deduction provided in section 172 is allowed to estates and trusts under regulations prescribed by the Secretary or his delegate. This provision is comparable to section 170 of the 1939 Code.

An estate or trust is allowed the deductions for depreciation and depletion only to the extent that these deductions are not allowable to beneficiaries. Under section 167 (g) and section 611, the allowable deductions for depreciation and depletion are apportioned between the income beneficiaries and the fiduciary in accordance with the pertinent provisions of the governing instrument or, in the absence of such provisions, on the basis of the trust income allocable to each. Under the amendments made by your committee to sections 167 and 611 of the House bill, the allowable deductions for depreciation and depletion are apportioned between an estate and its heirs, legatees, or devisees in accordance with the pertinent provisions of the governing instrument or, in the absence of such provisions on the basis of the income of the estate allocable to each.

The benefit of the deductions for amortization of emergency and grain-storage facilities is allowed to estates and trusts in the same manner as individuals but is apportioned between the income beneficiaries and the fiduciary under regulations. This provision is comparable to section 172 of the 1939 Code in the case of amortization of emergency and grain storage facilities.

Amounts which are allowable as deductions under the estate tax in computing the taxable estate of a decedent may not be allowed as a deduction in computing the taxable income of the decedent's estate unless a waiver of the right to claim the deductions for estate-tax purposes is filed pursuant to regulations. This provision does not apply, however, to any deduction allowable in connection with income in respect of a decedent. Subsection (g) is thus comparable to section 162 (e) of the 1939 Code.

Your committee has added a new subsection (h) which makes available to beneficiaries succeeding to the property from an estate or trust on termination any unused capital loss or net operating loss carryover or any deductions in excess of gross income for the last taxable year. This provision is comparable to section 662 (d) of the House bill, except that it limits the amount of deductions in excess of gross income which are made available to the beneficiaries to the deductions allowable in the final taxable year of the estate or trust. In the computation of such excess, the deduction allowed under subsection (b) for personal exemption and the deduction allowed under subsection (c) for amounts paid or permanently set aside for charitable purposes are not taken into account.

Section 643. Definitions applicable to subparts A, B, C, and D

This section corresponds to section 643 of the House bill, except for certain changes made in subsection (a) (3) and (4) and subsection (b).

This section contains the definitions of certain terms used in subparts A, B, C, and D.

Subsection (a) defines the term "distributable net income" to mean the taxable income of the estate or trust with certain modifications. This concept of distributable net income serves the general purposes of limiting the additional deductions allowed to estates and trusts (under sections 651 and 661) for amounts paid, credited, or required to be distributed to beneficiaries and also of determining how much of an amount distributed or required to be distributed to a beneficiary will be taxed to him. In effect, the concept of distributable net income gives statutory expression to the principle underlying the taxation of estates and trusts, that is, that these separate taxable entities are only conduits through which income flows to the beneficiaries except where income is accumulated by the estate or trust for future distribution. Since the distributable net income concept is used to determine the character of amounts distributed to a beneficiary, it is necessary to adjust the taxable income of the estate or trust by adding to it items of trust income which are not includible in the gross income of the estate or trust but which may nevertheless be available for distribution to the beneficiaries.

In computing distributable net income, the additional deduction allowed to an estate or trust fcr amounts paid, credited, or required to be distributed to beneficiaries is not taken into account. Similarly, the deduction for personal exemption allowed to an estate or trust under section 642 (b) is not taken into account. The benefit of these deductions is thus restricted to the estate or trust.

Your committee made certain technical changes in the treatment of capital gains and losses in computing distributable net income. To the extent that gains from the sale or exchange of capital assets are allocated to corpus and are not (A) paid or credited to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642 (c) (charitable deduction), they are excluded from the computation of distributable net income. The effect of this modification is to tax capital gains to the estate or trust where the gains must be or are added to principal. However, where the gains are actually distributed to beneficiaries during the taxable year—for example, in the year of termination of the trust—then the gains are included in the computation of distributable net income. Similarly, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642 (c) so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income. Losses from the sale or exchange of capital assets are excluded from the computation of distributable net income except to the extent that they enter into the determination of any net capital gains that are paid, credited, or required to be distributed to a beneficiary. The deduction for capital gains provided in section 1202 is not taken into account in computing distributable net income. If capital gains are accumulated, and thus excluded from the computation of distributable net income, the deduction under section 1202 is available only to the estate or trust. On the other hand, if capital gains are distributed to a beneficiary, they retain their character in the hands of the beneficiary and he becomes entitled to the deduction under section 1202 in respect of the gains.

For purposes only of subpart B (relating to trusts which distribute current income only) distributable net income is computed without regard to items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, deems to be allocable to corpus. For example, if a trust instrument should provide that only dividends paid out of corporate earnings accumulated or earned subsequent to the creation of the trust would be available for distribution to the income beneficiaries and that all other dividends should be accumulated for the remaindermen, any dividends which the trustee determines, in good faith, to be allocable to corpus must be excluded from distributable net income for purposes of subpart B. This provision is similar to the House bill, except that your committee deleted the word "cash" so that the provision will be applicable to dividends paid in kind, such as dividends of stock of other corporations, as well as to cash dividends.

There must be included in the computation of distributable net income the amount of any interest on governmental obligations which is exempt from tax under section 103, reduced by any disbursements allocable to such interest which are made nondeductible by section 265.

In the case of a foreign trust, there must be included in the computation of distributable net income the amount of gross income from sources outside the United States, reduced by any disbursements allocable to such income which are made nondeductible by section 265.

Distributable net income must also include the amount of any dividends received by the estate or trust which are excluded from gross income by section 116. Thus, if in the calendar year 1955 the estate or trust excludes the first $100 of dividends received in that year, the $100 so excluded must be taken into account in computing distributable net income.

If the estate or trust is allowed a deduction under section 642 (c) for charitable, etc., gifts and contributions, the items of exempt income, which are included in the computation of distributable net income, must be reduced to the extent that such items of trust income have been paid, permanently set aside or are to be used for the charitable, etc., purposes specified in section 642 (c). In determining whether amounts of trust income which have been paid, permanently set aside, or are to be used for charitable, etc., purposes include items of tax-exempt income, such amounts are deemed to consist of the same proportion of each class of items entering into the computation of trust income for trust accounting purposes as the total of each class bears to the total of all classes of trust income.

Subsection (b) provides that the term "income" when used in subparts A, B, C, and D, and when not preceded by the words, "taxable," "distributable net," "undistributed net," or "gross" means the income of the estate or trust as determined under its governing instrument and the applicable local law. This definition eliminates the difficulty occasioned in section 162 of the 1939 Code where the term "income" was used in certain contexts to mean "gross income" and in others to mean income for fiduciary accounting purposes. Conforming with the change made in subsection (a) (3), your committee deleted the word "cash" from the phrase "extraordinary cash dividends." Thus, items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary in good faith determines to be allocable to corpus are not considered income for purposes of subparts A, B, C, and D.

Subsection (c) provides that the term beneficiary includes an heir, devisee, or legatee.

SUBPART B—TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY

Section 651. Deduction for trusts distributing current income only

This section is identical to section 651 of the House bill.

This section provides an additional deduction for the amount of trust income for the taxable year which is required to be distributed currently. The section is applicable only to a trust which, for every year, under the terms of its governing instrument, (1) is required to distribute all of its income currently, and (2) does not provide that any amounts are to be paid, permanently set aside or used for the charitable, etc., purposes specified in section 642 (c). Even where a trust meets both of the above requirements, it does not qualify for treatment under this section in any taxable year in which it distributes amounts other than amounts of income which is required to be distributed currently. For example, a trust which is required to distribute all of its income currently will not be treated under this subpart in any year in which it makes distributions of corpus. Similarly, in the year of termination such a trust would not qualify under this subpart. The determination of whether trust income is required to be distributed currently depends upon the terms of the governing instrument and the applicable local law. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. To illustrate, assume that a trust, the terms of which require all of its income to be distributed currently, has $10,000 income for the calendar year 1955, of which $2,500 represents income collected in December that the trustee pays to its sole beneficiary A in March and April 1956. The trust would be entitled to a deduction under this section of $10,000 for its taxable year 1955 (assuming, for this purpose, that the limitations of subsection (b) do not apply) and beneficiary A (also on the calendar year basis) would be required to include $10,000 in gross income for 1955. If in 1956 the trust again has $10,000 of income but distributes income received in the last part of its year early in the following year, the trust will be taxed in the same manner as in 1955. The distributions of 1955 income in March and April 1956 do not disqualify the trust from treatment under subpart B in 1956 since these post-year-end distributions are distributions of income that is required to be distributed currently—i. e., income to which the beneficiary was entitled in 1955 as income required to be distributed currently, and as to which he was taxable for such prior year.

Subsection (b) provides a limitation on the deduction otherwise allowed to a trust under subsection (a). If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction is limited to the amount of the distributable net income. This limitation is necessary because the tax imposed on the beneficiaries with respect to the income required to be distributed currently to them is limited to the distributable net income of the trust. Thus, if capital gains, taxable stock dividends, or extraordinary dividends are determined by the fiduciary to be allocable to corpus, the trust rather than the beneficiary will be taxed on such items of gross income. For purposes of determining this limitation on the deduction, distributable net income is computed without regard to items of trust income (and the deductions allocable thereto) which are not included in the gross income of the trust. In effect, this means that distributable net income is computed for this purpose without the modifications specified in paragraphs (5), (6), and (7) of section 643 (a). Thus, the trust will not be permitted a deduction for distributions of trust income to the extent that the distributions represent items of income not included in the gross income of the trust.

Section 652. Inclusion of amounts in gross income of beneficiaries of trusts distributing current income only

This section is identical with section 652 of the House bill.

This section provides that the beneficiaries of a trust which is required to distribute all of its income currently are taxed on the amounts of income required to be distributed to them, whether distributed or not; however, if such amount exceeds the distributable net income of the trust, each beneficiary is taxed only on his proportionate share of the distributable net income. The proportionate share of each beneficiary is determined by taking the same fractional part of distributable net income as the amount of trust income required to be distributed to the beneficiary bears to the trust income required to be distributed to all beneficiaries. The effect of this limitation is to give the beneficiary the benefit of certain statutory deductions, such as trustees' commissions allocable to corpus, which are allowed to a trust under the 1939 Code but which may be wasted because the trust distributes all its income and thus has deductions in excess of gross income. Also, the limitation insures that the beneficiary will not be taxed on certain distributions to him that represent income under the local law applicable to trusts but that are not regarded as income to the trust for Federal income-tax purposes. Under certain decisions of existing law, a beneficiary has been held taxable on his distributable share of proceeds received by a trust from a defaulted mortgage even though the total proceeds were less than the principal of the mortgage debt, and the trust thus realized no gross income (*Johnston* v. *Helvering*, 141 F. 2d 208, 2d Cir. 1944, cert. den., 323 U. S.

715 (1945)). Similarly, the receipt by a beneficiary of a stock dividend that was not taxable in the hands of the trust was determined to be a taxable distribution in *McCullough* v. *Commissioner* ((153 F. 2d 345) 2d Cir. (1946)). Although similar results may or may not be reached in other cases, the limitation of this section should insure that such a construction will not arise in cases where the new provisions of this part are applicable and will preserve the conduit principle in this area.

Subsection (b) provides that the amounts which are determined under subsection (a) to be includible in the gross income of the beneficiary shall have the same character in the hands of the beneficiary as in the hands of the trust. If the beneficiary's proportionate share of distributable net income (as determined under subsection (a)) includes items of tax-exempt income, such as tax-exempt interest, such exempt income maintains its character in his hands and is therefore excluded from his gross income. However, if the beneficiary's proportionate share of distributable net income includes items of foreign income from a foreign trust, such items of foreign income will retain their character but will be taxable to the beneficiary depending upon his taxable status with respect to such items. Similarly, the same conduit concept is utilized in determining whether the amount includible in the gross income of the beneficiary (under subsection (a)) is composed of dividends as to which the beneficiary will be entitled to a dividends received credit under section 34 or is composed of capital gains as to which he will be taxed at capital gains rates rather than at ordinary income rates. Unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, the character of the amounts includible in each beneficiary's gross income under subsection (a) is determined by treating each such amount as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. In the application of this ratio the items of deduction of the trust that enter into the computation of distributable net income are to be allocated among the items of distributable net income in accordance with regulations.

Subsection (c) provides that if the taxable year of a beneficiary is different from that of the trust, the amount which the beneficiary must include in gross income pursuant to subsections (a) and (b) shall be based upon the trust income for any year or years ending with or within the beneficiary's taxable year. This provision is comparable to section 164 of the 1939 Code.

SUBPART C—ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS

Section 661. Deduction for estates and trusts accumulating income or distributing corpus

This section corresponds to section 661 of the House bill, except for a technical change in subsection (b).

This section (subject to the limitations discussed below) allows an additional deduction to estates or trusts for amounts paid, credited, or required to be distributed to beneficiaries. The section is applicable to all estates and to all trusts other than those which, for the taxable year, qualify under subpart B.

A deduction is allowed under subsection (a) for the sum of (1) any amount of trust income for the taxable year which is required to be distributed currently (including an annuity payable out of income or corpus, to the extent that it is paid out of income) and (2) any other amounts paid, credited, or required to be distributed for the taxable year; however, the deduction allowed under this section may not exceed the distributable net income of the estate or trust for its taxable year.

Subsection (b) provides that the amount determined under subsection (a) is to be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. Thus, if there is trust income of $100,000 composed of $50,000 of taxable income and $50,000 of tax-exempt income and the distributable net income is $98,000, then the amount determined under subsection (a) would be treated as consisting of the same proportions of taxable and tax-exempt income as each bears to the distributable net income. In the application of this ratio, the items of deduction which enter into the computation of distributable net income are to be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate. Assuming in the above example that the trust has $2,000 of deductions, one-half of which is attributable to taxable and one-half to tax-exempt income, and that the trust distributes all of its income, then the amount determined under subsection (a) would be deemed composed of $49,000 of taxable and $49,000 of tax-exempt income. To conform to the character rule in section 662 (b) your committee has added a clause providing that the allocation rule set forth in this subsection will apply only in the absence of specific provisions for allocation for different classes of income in the governing instrument.

Subsection (c) provides that the estate or trust is not allowed a deduction for distributable amounts to the extent that those amounts are composed of items of distributable net income not included in the gross income of the estate or trust. Thus, in the example contained in the preceding paragraph, the deduction allowed to the trust would be limited to $49,000, since the remaining portion ($49,000) of the distributable net income is deemed to consist of tax-exempt income.

Section 662. Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus

This section corresponds to section 661 of the House bill, except that subsection (d) is omitted.

The provisions of this section (taken together with the provisions of sec. 663 and subpart D) determine the extent to which beneficiaries of estates and trusts are taxable with respect to distributions either made or required to be made to them. The section applies to beneficiaries of estates and to beneficiaries of trusts other than those which, for the taxable year, qualify under subpart B.

Subsection (a) provides that the beneficiary of an estate or trust described in section 661 must include in gross income any amounts paid, credited, or required to be distributed to him for the taxable year of the estate or trust; however, the amount so includible may not exceed the beneficiary's proportionate share of the distributable net income. The effect of limiting the taxation of a beneficiary to his proportionate share of the distributable net income is to preserve the conduit principle by providing that all distributions (or amounts required to be distributed) from an estate or trust w ll be taxable but not to an extent in excess of the taxable income of the estate or trust (computed without regard to the deductions for distributions and for personal exemptions and without inclusion of capital gains allocable to corpus). It is thus possible largely to avoid the necessity for tracing of income which exists generally under existing law. Instead of determining whether a particular distribution represents amounts of current or accumulated trust income, this revision, broadly speaking, provides that any distribution is considered a distribution of the trust or estate's current income to the extent of its taxable income for the year. This principle is similar to the determination of whether a dividend has been distributed, i. e., that every distribution made by a corporation is deemed to be out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits.

In determining what constitutes a beneficiary's proportionate share of the distributable net income of the estate or trust, this section establishes an order of priority. Under paragraph (1) a beneficiary is required to include in gross income the amount of any income of the estate or trust which is required to be distributed to him currently, whether or not the income is actually distributed to him. For this purpose, income is determined under the governing instrument and the applicable local law. Included within the provisions of this paragraph is an annuity which is required to be paid at all events (either out of income or corpus) but only to the extent that it is satisfied out of income. If the income of the estate or trust which is required to be distributed currently exceeds the distributable net income (computed, for this purpose, without the charitable deduction allowed by sec. 642 (c)), then each beneficiary of such income, instead of being taxed on the income required to be distributed to him, is taxed only upon his proportionate part of the distributable net income. This is determined by attributing to him the same fractional part of distributable net income as the amount of trust income required to be distributed currently to such beneficiary bears to the trust income required to be distributed currently to all beneficiaries.

If the estate or trust pays, credits, or is required to distribute to beneficiaries amounts other than income which is required to be distributed currently, paragraph (2) provides that these other amounts (subject to the provisions of sec. 663) are includible in the gross income of the recipient beneficiaries but only to the extent of each beneficiary's proportionate share of the distributable net income (reduced by the amount of any income required to be distributed currently). The effect of the latter reduction is to insure (except as otherwise provided in subpart D) that recipients of other distributions are subject to tax on such distributions only if the amount of income required to be distributed currently fails to exhaust the distributable net income of the estate or trust. The beneficiary's proportionate share of the distributable net income (as thus reduced) is determined by taking the same fractional part of such distributable net income (as thus reduced) as the other amounts paid, credited, or required to be distributed to him to bear to the total of other amounts paid, credited, or required to be distributed to all beneficiaries. In this connection, an annuity which is required to be paid at all events but which is payable only out of corpus is treated as an "other amount * * * required to be distributed."

Although subsection (a) provides for the inclusion of amounts in the gross income of the beneficiaries to the extent of distributable net income of the estate or trust, its provisions are subject to the rules prescribed in subsection (b) which affirms that the amounts shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. Thus, to the extent that the beneficiary's proportionate share of distributable net income (as determined under subsec. (a)) is deemed to consist of tax-exempt income, he will not be required to include such portion in gross income. The conduit rule expressed in subsection (b) likewise enables the beneficiary to determine to what extent his proportionate share of distributable net income is deemed to be composed of dividends as to which he will be entitled to a dividends received credit against tax or to what extent it may be deemed composed of distributable capital gains as to which he will be taxable at capital gains rates. Furthermore, nonresident aliens will not be subject to tax on income from foreign sources to the extent deemed distributed. Unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, the amounts determined as includible in the gross income of the beneficiary under subsection (a) are to be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. In the application of this ratio, the items of deduction which enter into the computation of distributable net income (including the charitable deduction allowed under sec. 642 (c)) are to be allocated among the items of distributable net income in accordance with regulations.

Subsection (b) also provides that in its application to an amount determined under paragraph (1) of subsection (a), distributable net income is to be computed without regard to any portion of a charitable deduction allowed under section 642 (c) which is not attributable to income of the taxable year. For example, assume a trust provides that one-half of its income must be distributed currently to beneficiary A, and that the trustee in his discretion may either (1) accumulate the other one-half for beneficiaries B or C, (2) distribute such income to designated charities currently or (3) accumulate such income and pay the accumulations to the designated charities in subsequent years. If the trust for its taxable year has $40,000 of taxable income and $10,000 of tax-exempt income and the trustee distributes $25,000 to A and $50,000 to charity X (consisting of both current and accumulated income), distributable net income is $25,000 (the charitable deduction, for this purpose, being taken into account only to the extent of $25,000) and under the conduit rule of subsection (b) only $20,000 of the amount distributable to A is deemed to be taxable income in his hands.

Subsection (c) provides that if the taxable year of a beneficiary is different from that of the estate or trust, the amounts includible in the beneficiary's income under this section is to be based on the distributable net income of the estate or trust and on the amounts paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust that ends within or with his taxable year.

EXAMPLE OF THE APPLICATION OF SUBPART C

To illustrate the operation of subpart C assume the following case: The terms of a testamentary trust require that one-half of the trust income be distributed currently to the grantor's wife for her life. The remaining trust income, in the trustee's discretion may either be paid to the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of the grantor's wife and the principal will then be payable to the daughter. Under the applicable local law, capital gains realized by the trust are allocable to the principal account. The records of the fiduciary show the following for calendar year 1954:

Income from rents	$50, 000
Income from dividends of domestic corporations	50, 000
Tax-exempt interest on municipal bonds	20, 000
Partially tax-exempt interest on United States bonds	10, 000
Capital gains (long term) in excess of capital losses	20, 000
Depreciation on buildings	10, 000
Administrative expenses and local taxes attributable to rental income	15, 000
Administrative disbursements and trustee's commissions allocable to tax-exempt interest	1, 000
Other trustee's commissions allocable to income account	2, 200
Other trustee's commissions allocable to principal account	1, 100

On the basis of the above, the trust income for trust accounting purposes for 1954 is $111,800, consisting of all the above items except capital gains, depreciation, and other trustee's commissions allocable to principal account. The trustee distributes one-half of the trust income ($55,900) to the wife, and makes discretionary distributions of one-quarter of the income ($27,950) to charity X and the remaining one-quarter ($27,950) to the daughter.

Under section 661 (a) the trust is allowed an additional deduction for its distributions computed in the following manner:

The sum of (1) income required to be distributed currently and (2) other amounts properly paid or credited is $83,850 ($55,900+$27,950). The amount distributed to charity X is not taken into account since it is allowed as a deduction under section 642 (c) to the extent that such amounts are included in gross income of the trust.

It is necessary under section 661 (a) to determine whether the sum of the amounts described in paragraphs (1) and (2) of such section—here $83,850—exceeds distributable net income. Distributable net income is taxable income computed without the deductions for distributions and for the trust exemption and without including capital gains but including tax-exempt interest (reduced by disbursements allocable thereto and by any portion of such interest attributable to a charitable distribution) and $50 in dividends falling within section 116. Thus, distributable net income would be composed of $50,000 (rental income), $50,000 (dividends), $10,000 (partially tax-exempt interest) and $14,700 (tax-exempt interest) reduced by $15,000 (rental expenses), $2,200 (trustee's commissions allocable to income), $1,100 (trustee's commissions allocable to corpus) and $23,650 (charitable deduction allowed under sec. 642 (c)). The amount of tax-exempt interest includible in distributable net income is determined by reducing the total tax-exempt interest of $20,000 by the trust disbursements and trustee's commissions allocable thereto of $1,000 and by the amount of such interest attributable to the charitable distribution which is $4,300. The latter figure is the amount which bears the same ratio to the total amount distributed to the charity ($27,950) as the total tax-exempt interest of the trust ($20,000) bears to the total of all amounts of income entering into trust income ($130,000). The charitable deduction of $23,650 is determined by reducing the amount distributed to charity ($27,950) to the extent that such amount is composed of tax-exempt interest ($4,300).

Since distributable net income of $82,750 (as determined above) is less than the sum of the amounts distributed of $83,850, the deduction is limited to the distributable net income; however, section 661 (c) provides that no deduction may be allowed for an amount determined under section 661 (a) to the extent that it consists of items of distributable net income which are not included in gross income. Here, distributable net income is composed of $14,700 of tax-exempt interest and $50 in dividends falling within section 116. (Since disbursements and commissions and the portion of the charitable distribution are the only items allocable to such income in this illustration and have been taken into account in determining tax-exempt interest, the expenses entering into the computation of distributable net income are not allocated to tax-exempt interest under the character rule of subsection (b).) The allowable deduction under section 661 (a) is therefore $68,000 ($82,750—$14,750).

In computing the taxable income of the trust, the trust has gross income of $129,950 less total deductions of $120,050 which includes the following: Expenses and taxes attributable to rental income ($15,000); trustee's commissions allocable to income account ($2,200); trustee's commissions allocable to principal account ($1,100); charitable deduction ($23,650); deduction for capital gains under section 1202 ($10,000); deduction for personal exemption under section 642 (b) ($100). Thus, the trust is taxable on $9,900.

In computing the amount which is includible in the gross income of the wife, section 662 (a) (1) provides that the trust income of $55,900 which is required to be distributed to her is includible in her gross income; however, subsection (b) of section 662 provides that the amounts determined under subsection (a) shall have the same character in her hands as in the hands of the trust. In applying the ratio provided in subsection (b) distributable net income is deemed composed of the following amounts of each class of income: Rental income, $22,750; dividends, $37,750; partially tax-exempt interest, $7,550; tax-exempt interest, $14,700.

The figure for rental income is determined by reducing the rental income of $50,000 by the administrative expenses and taxes attributable thereto ($15,000) as well as by a pro rata share of all other deductions entering into distributable net income, or 50,000/110,000 of each of such deductions including the charitable deduction. (Since the disbursements, commissions, and proportionate share of the charitable contribution attributable to tax-exempt interest is already taken into account in determining the amount of tax-exempt interest includible in the computation of distributable net income, no part of the trust deductions are allocated to tax-exempt income.) The above amounts for dividends and partially tax-exempt interest are also determined by allocating to the amount of dividend income and of partially tax-exempt income a pro rata share of each of the deductions entering into the computation of distributable net income.

Thus, the $55,900 which the wife receives is deemed composed of $15,368 of rental income (22,750/82,750×$55,900); $25,501 of dividends (37,750/82,750×$55,900); $5,100 of partially tax-exempt interest (7,550/82,750×$55,900); and $9,930 of tax-exempt interest (14,700/82,750×$55,900). She will therefore exclude $9,930 of the distribution from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her—here, one-half of the total depreciation deduction or $5,000.

The amount includible in the gross income of the daughter is computed in a similar manner under section 662 except that, under subsection (a) (2), the sum of amount of income required to be distributed currently and the other amounts properly paid, credited, or required to be distributed ($83,850) exceeds distributable net income ($82,750). Hence, the amount determined under paragraph (2) of subsection (a) is $26,850 (distributable net income of $82,750 reduced by the amount of income required to be distributed currently of $55,900). In determining the character of this amount, the same proportions are applied as in the case of the wife so that $7,382 is deemed to be rental income (22,750/82,750×$26,850); $12,249 of dividend income (37,750/82,750×$26,850); $2,450 of partially tax-exempt interest ($7,550/82,750×$26,850); and $4,770 of tax-exempt interest (14,700/82,750×$26,850). Thus, the daughter will exclude $4,770 of the distribution from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively. In addition, she may deduct her proportionate share of the depreciation deduction or $2,500.

Section 663. Special rules applicable to sections 661 and 662

This section corresponds to section 663 of the House bill but contains several revisions of those provisions as well as the addition of two new provisions.

Subsection (a) (1) of your committee's bill is a revision of subsection (a) and subsection (b) (2) of the House bill. Your committee has provided that a gift or bequest of a specific sum of money or specific property which is properly paid or credited under the terms of the governing instrument and which is paid or credited to a beneficiary either in a lump sum or in not more than three installments will not be included as an amount falling within section 661 or 662. Thus, a lump-sum gift or bequest of specific property or of a specific sum of money will not be allowed as an additional deduction to the estate or trust under section 661, nor will it be deemed a distribution of taxable income to the beneficiary under section 662 provided that such gift or bequest is required by the specific terms of the will or trust instrument. Similarly, such a gift or bequest which is paid or credited in not more than three installments will be treated in the same manner as a lump-sum gift or bequest. However, if the governing instrument provides that the gift or bequest of specific property or a specific sum of money is payable only from the income of the estate or trust, an amount so payable will not be treated as an excluded gift or bequest under the above rule. For example, a legacy of $5,000 to beneficiary A would be excluded provided that it was paid or credited in a lump sum or in not more than 3 installments, while a legacy of $5,000 to A, which was payable only out of the income of the estate, would fall within the provisions of sections 661 and 662. Similarly, a distribution of $25,000 to beneficiary A, upon his attaining the age of 25 as provided in the trust instrument, would fall within the gift exclusion of this subsection; whereas, a distribution to A, upon his attaining the age of 25, of the accumulated income for the prior year or years of the trust under the terms of the trust instrument, would not be subject to the gift exclusion whether such amounts were payable only out of accumulated income or were payable either out of income or corpus.

Subsection (a) (2) corresponds to subsection (b) (3) of the House bill. It provides that any amount paid, permanently set aside, or to be used for the purposes specified in section 642 (c) (relating to charitable, etc., deductions) is excluded from the provisions of sections 661 and 662. For this purpose the deduction provided in section 642 (c) is computed without regard to section 681. Since the estate or trust is allowed a deduction under section 642 (c) for amounts paid, permanently set aside, or otherwise qualifying for the deduction provided in that section, such amounts are not allowed as an additional deduction for distributions, nor are they treated as amounts distributed for purposes of section 662 in determining the amounts includible in gross income of the beneficiaries.

Subsection (b) (1) of the House bill has been deleted by your committee's amendment. Under the House provision a final distribution was treated as an excluded amount but only to the extent that such final distribution did not consist of gross income of the estate or trust. Since on termination of an estate or trust the amount allowed as an additional deduction under section 661 and treated as taxable to the beneficiary under section 662 is limited to the distributable net income of the estate or trust for its final taxable year, the House provision has little application except as to amounts treated as falling within sections 661 and 662 by reason of subpart D. Your committee has added a specific exception in section 665 in subpart D dealing with amounts paid or credited to a beneficiary as a final distribution of the trust. In view of this amendment to subpart D, the retention of subsection (b) (1) of the House bill appears unnecessary.

Your committee has added a new provision in paragraph (3) of subsection (a) which will insure that an amount which is paid, credited, or distributed in the taxable year will not be treated as an amount falling within section 661 or 662 if section 651 or 661 applied to such amount for a prior taxable year because such amount was credited or required to be distributed in the prior year. For example, if an amount is required to be distributed currently by a trust to beneficiary A in 1955 but is not, in fact, distributed until 1956 (both the trust and A being on a calendar year basis), the amount will be treated under sections 651 and 652 for 1955 when it is required to be distributed instead of under sections 661 and 662 in 1956 when it is, in fact, distributed.

Subsections (b) and (c) also represent additional provisions to the House bill added by your committee.

Under subsection (b) the fiduciary of a trust may elect to treat distributions within the first 65 days of the taxable year of the trust as amounts which were paid or credited on the last day of the preceding taxable year. The election is only available if the trust was created prior to January 1, 1954, and if the terms of the trust instrument provide that the trust may not distribute in any taxable year amounts in excess of the trust income for the immediately preceding taxable year. The election is only applicable to the first taxable year of the trust to which the new provisions of this part apply and must be made not later than the time prescribed by law for filing the return for such year (including extensions of time for filing the return). Once made, the election is irrevocable with respect to all subsequent taxable years. It applies not only to the amount allowable as an additional deduction to the trust under section 661, but also to the amount treated as taxable to the recipient beneficiary under section 662.

Subsection (c) is also applicable only to trusts. It provides that in the case of a single trust having more than one beneficiary, if the share of one or more of the beneficiaries is to be treated under the trust instrument as a substantially separate and independent share (and is so administered by the fiduciary), then, for purposes of determining the amount of distributable net income in the application of sections 661 and 662, each such separate share shall be deemed a separate trust. The determination of when a trust is regarded as having substantially separate and independent shares within the meaning of this provision and the manner in which such separate shares are to be treated as separate trusts is left to regulations to be prescribed by the Secretary or his delegate. The effect of this provision is to prevent a beneficiary from being subjected to tax on a distribution which represents a corpus distribution as to him but which would, except for this provision, be treated as a taxable distribution, since the trust income is being accumulated for another beneficiary to whom it will ultimately be made available. For example, assume that a trust instrument provides that the trust income when not distributed to beneficiary A will be accumulated for his benefit and will ultimately be payable to his estate, or appointees (including persons named as alternate takers in default of appointment). The trust instrument also provides that the fiduciary may invade corpus from time to time to make payments to B, according to B's needs. In a year in which the trustee accumulated the trust income for A but made a discretionary distribution of corpus to B, B would, but for the operation of this provision, be deemed taxable on the distribution to the extent of the trust's distributable net income. Under this provision if A is deemed to have a substantially separate and independent share in the trust, the trust income would be taxable to the fiduciary and B would receive the corpus distribution free of tax. This treatment of separate shares as separate trusts, however, is only for the purpose of determining distributable net income in applying sections 661 and 662. It cannot be applied, for example, to obtain more than one deduction for personal exemption under section 642 (b) or to permit the splitting of undistributed income oi the trust into several shares for purposes of being taxed at lower-bracket rates.

SUBPART D—TREATMENT OF EXCESS DISTRIBUTIONS BY TRUSTS

Subpart D applies to any trust which has for a taxable year beginning after December 31, 1953, an accumulation distribution determined under section 665 (b) and which is subject for such taxable year to the provisions of subpart C (relating to trusts which may accumulate income or distribute corpus). Subpart D does not apply to a trust which for the taxable year falls within the provisions of subpart B (relating to trusts which distribute current income only). Furthermore, subpart D does not apply to an estate.

Section 665. Definitions applicable to subpart D

This section corresponds to section 665 of the House bill but some of the provisions of that section have been changed.

Section 665 (a) defines undistributed net income for any taxable year. Undistributed net income for any taxable year is the excess of distributable net income (determined in accordance with section 643) of the trust for such taxable year over the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year), plus

(2) any other amounts properly paid or credited or required to be distributed in such taxable year, plus

(3) the amount of taxes imposed on the trust.

In determining the amounts falling within paragraph (1) of section 665 (a) for the purpose of ascertaining the undistributed net income for a particular taxable year, the application of this subpart to accumulation distributions of subsequent taxable years shall be taken into account to the extent deemed a distribution on the last day of such particular taxable year. In applying subpart D to an accumulation distribution of a taxable year, the undistributed net income of any preceding taxable year is determined without taking into account the application of this subpart to such accumulation distribution for such taxable year.

The amount of taxes for any taxable year imposed on the trust falls within paragraph (2) of section 665 (a), and is the amount which remains after taking into account the taxes allowed as a credit under sections 667 and 668 (b) because of accumulation distributions for subsequent taxable years which fall within section 666.

Subsection (b) of section 665 defines the accumulation distribution of a trust. An accumulation distribution of a trust for any taxable year is the amount (but only if more than $2,000) by which (1) amounts falling within paragraph (2) of section 661 (a) for such taxable year exceeds (2) distributable net income reduced by the amounts falling within paragraph (1) of section 661 (a) for such taxable year. The determination of an accumulation distribution of a trust for any taxable year is made without regard to section 666.

In making the determination whether there is an accumulation distribution for any taxable year, your committee has changed paragraphs (1) and (2) of section 665 (b).

Paragraph (1) of section 665 (b) of the House bill provided that in making the determination whether there is an accumulation distribution for any taxable year there shall not be included amounts paid, credited, or required to be distributed to the beneficiary as income accumulated during the minority or before the birth of the beneficiary. Your committee has changed this provision so that amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before such beneficiary attains the age of 21 will not be included in determining whether there has been an accumulation distribution. It is believed that a uniform age applicable to all trusts is preferable to a rule which may vary among States because of different ages at which individuals reach their majority. It is anticipated that the Secretary or his delegate will by regulations prescribe rules for the determination of the source from which amounts are distributed by a trust to a beneficiary for the purposes of ascertaining whether such amounts are distributed as income accumulated before the birth of such beneficiary or before such beneficiary attained the age of 21.

Paragraph (2) of section 665 (b) of the House bill provided that in making the determination whether there is an accumulation distribution for any taxable year there shall not be included amounts properly paid or credited for the support, maintenance, or education of the beneficiary. Your committee has changed this provision so that only an amount properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary will not be included in determining whether there has been an accumulation distribution. The attention of your committee was called to the fact that under the House bill this paragraph might exclude ordinary distributions from the application of this subpart since many trusts are set up for the purposes of providing for the support, maintenance, or education of their beneficiaries. Accordingly, your committee has limited the exclusion under this paragraph to only an amount which is distributed to a beneficiary clearly to meet his emergency needs. Whether or not a distribution falls within this paragraph depends upon the facts and circumstances causing such a distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify. However, the beneficiary must be in actual need of the distribution. The fact that a beneficiary has other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs.

Your committee has added a further exception to section 665 (b). Amounts properly paid or credited to a beneficiary upon such beneficiary attaining a specified age or ages will not be included in the determination of an accumulation distribution if—

(1) the total number of such distributions cannot exceed four with respect to such beneficiary;

(2) the period between each such distribution is 4 years or more, and

(3) as of January 1, 1954, such distributions are required by the specific terms of the governing instrument.

Your committee has added a paragraph (4) so as to accomplish the same purpose as section 663 (b) (1) of the House bill. However, your committee provides that final distributions should not be excluded from the application of this subpart unless they are made more than 10 years after the date of the last transfer to the trust. This will prevent the setting up of trusts for the purposes of accumulating income and making final distributions within reasonably short periods so as to avoid the application of this subpart.

Subsection (c) of section 665 sets forth the rule for determining as of any time the "taxes imposed on the trust" for any particular taxable year. Taxes imposed on the trust under this chapter for any particular taxable year is the amount of taxes imposed on such trust under this chapter reduced by the amount of such taxes allowed under sections 667 and 668, as a credit to any beneficiary on account of the application to such taxable year of this subpart with respect to any accumulation distribution for any subsequent taxable years.

Your committee has made a technical change in subsection (c) of section 665 so as to limit the amount of "taxes imposed on the trust" to the portion of such taxes which, under regulations prescribed by the Secretary or his delegate, are properly allocable to the undistributed portion of distributable net income. For example, if a trust has capital gains which are allocable to corpus, the portion of the tax imposed on the trust which is properly allocable to such gains will not be included for the purposes of determining the amount of taxes imposed on the trust for purposes of this subpart.

Your committee has revised subsection (d) of section 665. A technical change has been made so as to define a preceding taxable year as not including a taxable year to which this part is not applicable. Furthermore, as presently drafted subpart D does not technically apply to a trust which for a preceding taxable year qualified under subpart B. In order to permit the application of this subpart to a preceding taxable year of a trust in which it qualified under subpart B, a new sentence has been added to subsection (c) of section 665. This sentence provides that in case of a preceding taxable year with respect to which a trust qualifies (without regard to this subpart) under provisions of subpart B, for the purposes of the application of this subpart to such trust for such taxable year, such trust for such taxable year shall, in accordance with regulations prescribed by the Secretary or his delegate, be treated as a trust to which subpart C applies. Thus, distributions of extraordinary dividends accumulated by the trustee, which are not treated as income by the trustee in the year in which received by the trust, will fall within the provisions of subpart D.

Section 666. Accumulation distribution allocated to 5 preceding years

This section is identical with section 666 of the House bill and is new.

This section applies to taxable years beginning after December 31, 1953. Under subsection (a) the amount of the accumulation distribution of a trust, determined for any taxable year under section 665 (b), is deemed to have been distributed on the last day of each of the 5 preceding taxable years as an amount within the meaning of paragraph (2) of section 661 (a), but only to the extent specifically provided in this subsection. If in any of such 5 preceding taxable years there is no undistributed net income for such year, determined under section 665 (a), prior to the application of this subsection with respect to the accumulation distribution for the taxable year, then there is no portion of such accumulation distribution for such taxable year which is deemed to be distributed on the last day of such preceding taxable year. The determination as to whether there is undistributed net income for any such preceding taxable year is made with the application of this subpart to accumulation distributions for any taxable years preceding the taxable year of the accumulation distribution with respect to which this subpart is being applied. Thus, for the purposes of applying this subsection to any taxable year, the undistributed net income for each of the 5 preceding taxable years shall be computed without regard to the accumulation distribution of such taxable year and without regard to any accumulation distribution determined for any taxable years following such taxable year. The amount of an accumulation distribution for any taxable year which is deemed distributed as of the close of any of the 5 preceding taxable years is the amount of such accumulation distribution reduced by the sum of the undistributed net incomes for any taxable years intervening between such taxable year and any such preceding taxable year with respect to which the amount to be deemed distributed is being computed.

Subsection (b) of section 666 applies where the amount deemed under subsection (a) to be distributed in any preceding taxable year is equal to the undistributed net income for such preceding taxable year. In such a case the trust is deemed to have distributed on the last day of any such preceding taxable year an amount, in addition to the amount determined under subsection (a), equal to the taxes imposed on the trust prior to the application of subsection (a) to such preceding taxable year with respect to such accumulation distribution. The amount deemed distributed under subsection (b) is treated as an amount distributed by the trust under section 661 (a) (2) on the last day of such preceding taxable year. For the purpose of subsection (b) undistributed net income for any preceding taxable year shall be computed without regard to the accumulation distribution of the taxable year or of any taxable year following such taxable year.

Subsection (c) of section 666 applies where the amount deemed under subsection (a) to be distributed in any preceding taxable year is less than undistributed net income for such preceding taxable year. In such a case the trust is deemed to have distributed on the last day of such preceding taxable year an amount, in addition to the amount determined under subsection (a), equal to the taxes imposed on the trust for such preceding taxable year multiplied by the fraction the numerator of which is the amount of the accumulation distribution deemed distributed under subsection (a) and the denominator of which is the undistributed net income for such preceding taxable year. For purposes of this subsection undistributed net income for any preceding taxable year shall be computed without regard to the accumulation distribution of the taxable year and without regard to any accumulation distribution determined for any taxable year following such taxable year, but such undistributed net income for the purposes of subsections (b) and (c) of section 666 shall be computed with regard to any accumulation distributions for taxable years prior to such taxable year.

Section 667. Denial of refund to trusts

This section corresponds to section 667 of the House bill.

Section 667 denies a refund or credit to the trust for the taxes paid by the trust under this chapter which would not have been paid by such trust had the trust in fact made the distributions deemed to have been made under section 666 on the last day of any preceding taxable year. Thus, subpart D does not require any reopening of the returns of the trust.

Your committee has added a new sentence to section 667 so that the method will be clear by which the credit permitted by thi3 section and by section 668 (b) is computed. In determining the amount of taxes which may not be refunded or credited to the trust such amount shall be equal to the excess of—

(1) the taxes imposed on the trust for any preceding year (computed without regard to the accumulation distribution for the taxable year) over

(2) the amount of taxes for such preceding taxable year imposed on the undistributed portion of the distributable net income of the trust for such preceding taxable year after the application of this subpart on account of the accumulation distribution determined for such taxable year.

Section 668. Treatment of amounts deemed distributed in preceding years

This section corresponds to section 668 of the House bill.

Section 668 provides that the total of the amounts determined under section 666 and treated under such section as having been distributed by the trust on the last days of the preceding 5 taxable years shall be included in the income of beneficiaries receiving such amounts in the taxable year when such amounts were in fact paid, or credited, or required to be distributed. The total of such amounts are includible to the extent such amounts would have been included in the income of the beneficiaries had such total actually been received by the beneficiaries on the last day of the preceding taxable years at which time they are deemed to have been distributed. The extent to which the total of such amounts are includible in the income of the beneficiaries is determined under sections 662 (a) (2) and 662 (b). The amount of tax imposed on the amounts in the taxable year when actually received shall not exceed the aggregate of the taxes which would have been payable by the beneficiary had such amounts been received by him at the times specified in section 666. The tax which would have been so payable is the excess of the tax computed by including such amounts over the tax imposed on the beneficiary without regard to such amounts for the particular year.

Your committee has made a technical change in the first sentence of section 668 (a) as it appeared in the House bill so as to make certain that a beneficiary receiving a distribution in a taxable year which is subject to the provisions of this subpart will be subject to the application of this subpart as if such amount had been distributed in any preceding taxable years in accordance with section 666 even though during any of such preceding taxable years such beneficiary would not have been a beneficiary if such distribution had actually been made in such preceding taxable years.

Furthermore, your committee has added a sentence at the end of the first sentence of section 668 (a) so that it is clear that the portion of the distributions included in the income of the beneficiary as of the last day of any preceding taxable years shall be based upon the same ratio as determined under the second sentence of section 662 (a) (2) for the taxable year in respect of which the accumulation distribution is determined.

Section 668 (b) of the House bill has been revised by your committee so as to provide that the tax imposed on beneficiaries under this chapter shall be credited with the pro rata portion of the taxes imposed on the trust under this chapter for such preceding taxable year which would not have been payable by the trust for such preceding taxable year had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666. This revision of section 668 (b) is a change from the House bill so as to permit the credit against the entire tax imposed on the beneficiaries for the year in which the amounts specified in subsection (a) are included in the income of such beneficiary rather than, as provided in the House bill, to limit the credit to the taxes applicable to such amounts included in income of such beneficiaries in accordance with subsection (a) of section 666.

EXAMPLE OF THE APPLICATION OF SUBPART D

Assume that a trust is required to distribute currently one-half of its income to beneficiary A and that the trustee has full discretionary power to distribute the remaining income to beneficiaries B or C in whatever amounts he sees fit. Assume further that the trust had the following amounts of income during its taxable years, 1954, 1955, and 1956.

	Royalties	Interest (taxable)	Interest (exempt)
1954	$20,000	$10,000	$5,000
1955	15,000	10,000	5,000
1956	25,000	15,000	5,000

1954.—Assume that the trustee in 1954 only distributed the one-half of the trust income for that year. The beneficiary A would receive $17,500 and would be taxed on $15,000. He would be exempt from tax on $2,500 as his portion of the tax-exempt interest. Under section 661 the trust would be entitled to a deduction of $15,000, and thus its taxable income would be $15,000. Taking into account the deduction under section 642 (b) of $100, the tax imposed on the trust as of the close of 1954 is $4,683. The undistributed net income of the trust as of the close of 1954 is ($17,500 minus $4,683) $12,817.

1955.—Assume that the trustee in 1955 distributed the one-half of the trust income to beneficiary A and $6,000 to beneficiary B. Beneficiary A would receive $15,000 and would be taxed on $12,500. Beneficiary B would be taxed on $5,000. Each beneficiary would be exempt from tax on $2,500 and $1,000 of tax-exempt interest, respectively. Under section 661 the trust would be entitled to a deduction of $17,500, and thus its taxable income would be $7,500. Taking into account the deduction under section 642 (b) of $100, the tax imposed on the trust for 1955 at the close is $1,780. The undistributed net income as of the close of 1955 is ($9,000 minus $1,780) $7,220.

1956.—Assume (1) that the trustee in 1956 distributed one-half of the trust income to beneficiary A, (2) that the trustee distributed to beneficiary B $20,000, and (3) that the trustee distributed to beneficiary C $10,000.

Beneficiary A would receive $22,500 and would be taxed on $20,000. He would be exempt from tax on $2,500 of tax-exempt interest.

Beneficiary B would, without regard to subpart D, be subject under section 662 to tax on $13,333.33 and would be exempt on $1,666.66 as tax-exempt interest.

Beneficiary C would, without regard to subpart D, be subject under section 662 to tax on $6,666.67 and would be exempt on $833.33 as tax-exempt interest.

For 1956, there would be no tax on the trust since the taxable income of the trust is $40,000 minus $20,000 taxable income distributed to beneficiary A, plus $13,333.33 as taxable income distributed to beneficiary B, plus $6,666.67 as taxable income distributed to beneficiary C.

Under subpart D, beneficiaries B and C would be subject to tax in their 1956 returns on amounts deemed distributed under section 666 on the last day of each of the two preceding taxable years, 1955 and 1954.

Under section 665 (b) the trust has for 1956 an accumulation distribution in the amount of $7,500. This amount is computed by subtracting $22,500 (distributable net income reduced by amounts falling within section 661 (a) (1)) from the total of all amounts for 1956 falling within section 661 (a) (2); i. e., $30,000. Under section 666 (a) the accumulation distribution of $7,500 is deemed to have been distributed as an amount specified in section 661 (a) (2) on the last day of each of the years 1954 and 1955. However, the amount of the $7,500 accumulation distribution deemed distributed in 1954 is the excess of such amount over the undistributed net income for 1955; i. e., the excess of $7,500 over $7,220, or $280. The amount of the $7,500 accumulation distribution deemed distributed in 1955 cannot exceed the undistributed net income for 1955 (computed without regard to such accumulation distribution). Thus, under section 666 (a), $7,220 is deemed distributed on the last day of 1955.

Since the portion of the accumulation distribution for 1956 which is deemed distributed in 1955 is not less than the undistributed net income for 1955, the trust is deemed under section 666 (b) to have distributed on the last day of 1955 an amount in addition to the $7,220. This additional amount is equal to the taxes imposed on the trust for 1955, i. e., $1,780.

Since the portion of the accumulation distribution for 1956 which is deemed distributed in 1954 is less than the undistributed net income for such year of $12,817, the trust is deemed under section 666 (c) to have distributed an amount in addition to the $280. This additional amount is the amount which is equal to the taxes imposed on the trust for 1954 ($4,683) multiplied by a fraction the numerator of which is $280 and the denominator of which is $12,817. This additional amount is $102.30.

As the result of the application of subpart D to the accumulation distribution of $7,500 for 1956, the trust is deemed to have distributed the following amounts:

(1) On the last day of 1955, the total amount of $9,000.

(2) On the last day of 1954, the total amount of $382.30;

Under section 668 (a) the total of the amounts which are treated under section 666 as having been distributed by the trust on the last day of any of the 5 preceding taxable years must, subject to sections 662 (a) (2) and 662 (b), be included in the income of the beneficiaries when in fact paid, credited, or required to be distributed.

Beneficiary B is deemed to receive $6,000 on the last day of 1955. He includes in his income for 1956, resulting from the application of subpart D to 1955, $5,000 and is exempt with respect to $1,000. Beneficiary B is deemed to receive $254.86 on the last day of 1954. He also includes in his income for 1956 resulting from the application of subpart D to 1954, $218.46, and is exempt with respect to $36.40.

Beneficiary C is deemed to receive $3,000 on the last day of 1955. He includes in his income for 1956, resulting from the application of subpart D, $2,500 and is exempt with respect to $500. Beneficiary C is deemed to receive $127.44 on the last day of 1954. He also includes in his income for 1956, resulting from the application of subpart D, $109.24, and is exempt with respect to $18.20.

The trust is not permitted any refund or credit for the amount of taxes imposed on the trust which would not have been payable by the trust had the trust in fact made the distributions deemed to have been made on the last days of 1954 and 1955 resulting from the application of this subpart to the $7,500 accumulation distribution for 1956.

Beneficiaries B and C are entitled to a credit under section 668 (b) against each of their tax for 1956 for a pro rata portion of the taxes imposed on the trust prior to the application of this subpart to the accumulation distribution for 1956 which would not have been payable in 1954 and 1955 had the trust in fact made the distributions to such beneficiaries resulting therefrom.

Since for 1955 the amount deemed under section 666 (a) to have been distributed was equal to the entire undistributed net income for that year, the entire amount of taxes imposed on the trust ($1,780) is allowed as a credit against the taxes imposed on the beneficiaries. In this case beneficiary B is permitted to credit against his tax the amount of $1,086.67 which is two-thirds of $1,780. Beneficiary C is permitted to credit against his tax for 1956 the amount of $593.33 which is one-third of $1,780.

With respect to 1954, prior to the application of this subpart to the accumulation distribution of $7,500 for 1956, the trust had undistributed net income of $12,817 and the tax was $4,683. After the application of subpart D, the undistributed portion of distributable net income for 1954 is $17,117.70 and the tax applicable to such portion is $4,528.99. Since the tax imposed on the trust prior to the application of this subpart to 1954 was $4,683, $154.01 is the amount of the taxes imposed on the trust under this chapter for 1954 which would not have been payable by the trust for 1954 had the trust in fact made distributions to beneficiaries B and C at the times and in the amounts specified in section 666.

Beneficiary B will be allowed an additional credit against his 1956 tax of $102.67, and beneficiary C, $51.34.

The undistributed net income for the year 1954 as of the close of 1956 is $12,588.71.

SUBPART E—GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS

Subpart E contains the provisions for taxing to the grantor the income of a trust over which he has retained substantial dominion and control. Under existing law, certain trusts of this character are specifically defined in sections 166 and 167 of the 1939 Code. Section 166 applies where there is vested in the grantor (or in a person not having a substantial adverse interest) a power to revest in the grantor the corpus of the trust, while section 167 applies to trusts the income of which may be distributed to the grantor directly, accumulated for future distribution to him, or applied to the payment of insurance premiums on policies on his life. Income of certain other trusts of which the grantor may be considered to be the owner has been held taxable to the grantor under the general provisions of section 22 (a), as construed in the decision of the Supreme Court in *Helvering* v. *Clifford* (309 U. S. 331) and related cases. These include certain short-term trusts providing for reversion to the grantor at the end of the term, and trusts where the grantor has retained the power to determine the beneficiary who is to enjoy the income. The principles for determining taxability of these trusts have been the subject of detailed regulations, section 39.22 (a)-21 of Regulations 118.

Under the new code, the rules for determining taxability of trusts falling within the purview of.section 22 (a) as well as those covered by sections 166 and 167 are brought together in this subpart. While, in general, the criteria for determining taxability under the Clifford doctrine follows the pattern of the regulations, that is, the dominant types of control are stated to be (1) the reversion of the trust property within a short period of time after the creation of the trust, (2) the reservation of the power to determine who should enjoy the corpus or income, and (3) the reservation of important administrative controls in a nonfiduciary capacity, there are variations in the precise standards selected. These are discussed under the various sections.

There is also included in this subpart (sec. 678) provision for taxing income of a trust to a person other than the grantor where there is vested in such person (rather than in the grantor) the power to vest the corpus or income in himself. This adopts the doctrine of such cases as *Richardson* v. *Commissioner* (121 F. 2d 1) and *Mallinckrodt* v. *Nunan* (146 F. 2d 1), now set forth in the regulations under section 22 (a). See section 39.22 (a)-22.

Section 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners

This section is identical with section 671 of the House bill.

This section states the general rule that in cases where the grantor or another person is regarded as the owner of any portion of a trust, there shall be included in computing his taxable income and credits those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust (to the extent that such items would be taken into account in computing the taxable income and credits of an individual). Thus, if income of a trust is attributable to the grantor because he has reserved the power to revoke the trust and if the trust has incurred certain expenses in connection with the production of such income, the income will be included in the income of the grantor and he will be allowed those deductions for such expenses which he would have been entitled to if the trust had not been created. If a portion of the income is paid to a charity, such payment shall be treated as though made by the grantor and will be cumulated with his other contributions for purposes of the limitations of section 170.

It is also provided in this section that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22 (a) of existing law). The effect of this provision is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in *Lucas* v. *Earl* (281 U. S. 111), *Harrison* v. *Schaffner* (312 U. S. 579), and *Helvering* v. *Horst* (311 U. S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart. This subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.

Section 672. Definitions and rules

This section corresponds to section 672 of the House bill.

This section contains definitions and rules for applying the other provisions of this subpart, including the definition of an adverse party, a nonadverse party and a related and subordinate party. These definitions are significant in any case where a power is held, not directly by the grantor, but by some other person whose actions may be attributed to the grantor. Thus, as under existing law, a power is not attributed to the grantor when held by a person who has a substantial interest in the trust property which is adverse to the interest of the grantor. Under subsection (a) of this section, such a person is defined as one having a substantial beneficial interest in the trust which would be adversely affected by his exercise or nonexercise of the power. A nonadverse party is defined in subsection (b) as any person not having an adverse interest.

Your committee has added a provision to insure that a person possessing a general power of appointment over the trust property will be treated as having a "beneficial interest" in the property in accordance with the economic realities of the situation. This treatment of a general power of appointment as a property interest is consistent with the provisions of section 2041 (b) (1) (C) (ii).

Subsection (c) defines a related or subordinate party to mean the grantor's spouse or certain specifically designated close relatives or subordinate employees of the grantor whose relationship to the grantor is such that a power held by such person may be tantamount to a power in the grantor. The persons are, in general, the same as are enumerated in section 39.22 (a)-21 (d) (2) of the regulations, except that this section adds to the class a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control. Under the regulations, an employee of such a corporation is specifically listed as within the subordinate group, but not the corporation itself.

While, under existing law, a power held by the grantor's spouse or by a related or subordinate party may be attributed to the grantor solely by reason of the relationship, under this subpart, such a result will follow only if the party is subservient to the grantor. This section provides, however, that such subserviency will be presumed unless the party is proved to be nonsubservient by a preponderance of the evidence. (Under the House bill, a "clear" preponderance of the evidence is required.) This rule, however, does not modify the rule of existing law where the power is one which permits the return of the corpus or income to the grantor, as provided in sections 676 and 677, corresponding to sections 166 and 167 of the 1939 Code. Under those sections, a power is in effect attributed to the grantor if held by any nonadverse party, regardless of relationship.

Subsection (d) contains the rule that a person shall be considered to have a power even though the exercise is subject to the precedent giving of notice or takes effect only on the expiration of a certain period of time after the exercise of the power. This provision, which is designed to prevent avoidance through the use of contingent powers, corresponds to the similar provision in section 39.22 (a)-21 (d) of the regulations. The fact that a power is held in the capacity of trustee is not material except where expressly or impliedly stated, as in sections 674 (d) and 675 (4).

Section 673. Reversionary interests

This section is identical with section 673 of the House bill.

This section contains the rules applicable to the short-term trust containing the provision for a reversion to the grantor. The section enacts in statutory form provisions in lieu of those now contained in section 39.22 (a)-21 (c) of Regulations 118.

Subsection (a) of this section contains the general rule that a grantor shall be considered to be the owner of any portion of a trust (and taxable on the income therefrom) in which he has a reversionary interest in either the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment within a period of 10 years.

Subsection (b) provides a special rule under which income of a short-term trust is taxed to the grantor only where the term is for less than 2 years, if the income of the trust is irrevocably payable to any of the following organizations which are exempt from tax under section 501: A church; a convention or association of churches; a religious order; a hospital; or an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The provisions of subsection (b) will not apply unless the income for the entire term must be paid to the single specifically designated beneficiary. Thus, the subsection will not apply if the income is payable, in the discretion of the trustee, to any one or more of several named colleges.

Subsection (c) contains a further exception to the rule of subsection (a) to the effect that the grantor shall not be treated as the owner of a trust by reason of a reversionary interest where such interest is to take effect only on the death of the person or persons to whom the income is payable. This rule is applicable even though, due to the short life expectancy of the beneficiary, the reversionary interest may reasonably be expected to take effect within 10 years.

Subsection (d) provides the rule (also contained in the regulations) under which a postponement of the date for reacquisition of the property is considered to constitute a new transfer in trust commencing with the date of the postponement, for the purpose of determining whether a short-term trust is in effect following the postponement. However, the income will not be taxed to the grantor by reason of the extension of the term for any year in which it would not be taxed to him in the absence of the postponement. Thus, if a trust which originally was for a term of 12 years is extended at the end of the ninth year so that it will have a total term of 14 years, a new 5-year trust is considered to have been created. However, the income of the first 3 years of such new term is not attributed to the grantor since these years constitute the tenth, eleventh, and twelfth years of the original 12-year trust.

Section 674. Power to control beneficial enjoyment

This section corresponds to section 674 of the House bill.

This section contains provisions similar to those contained in subsection (d) of section 39.22 (a)–21 of the regulations, providing for taxability to the grantor of income of a trust where the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by the grantor or by a nonadverse party or both. The general rule is contained in subsection (a) of this section while certain excepted powers are described in subsections (b), (c), and (d).

Paragraph (1) of subsection (b) contains the exception, equivalent to that provided in section 167 (c) of the 1939 Code, under which a grantor is not taxable on income of a trust by reason of a power merely to apply income to the support or maintenance of his dependents. Inasmuch as such a power might subject the grantor to tax under the general rule of this section as well as under the general rule of section 677 (corresponding to sec. 167 of existing law) the exception is provided for in both sections.

Paragraph (2) contains an exception, also provided in the regulations, to the rules set forth in section 672 (d), under which powers exercisable only on giving of notice or at a future date are treated as present powers. Thus under the exception, a power which may only affect the income for a period commencing after 10 years will not subject the grantor to tax during the prior period. This exception correlates with the short-term trust rule in order that more severe tax consequences may not result from a power exercisable after a term of 10 years than from a reversionary interest to take effect after the same period. If the power is still in existence in the eleventh and succeeding years, however, the grantor will be taxable on the income of those years under the general rule since the power will be currently exercisable. While this rule is implicit in the House bill it has, in the interests of clarity, been specifically set forth by your committee.

Paragraph (3) contains the rules presently in paragraph (2) (i) of subsection (d) of section 39.22 (a)–21 with respect to a power exercisable only by will. Such a power subjects the grantor to tax only where the income is accumulated for testamentary disposition by the grantor, or may be accumulated for such disposition in the discretion of the grantor or a nonadverse party.

Paragraph (4) excepts a power to determine the beneficiaries of the income or corpus provided that payment must be made for a charitable purpose as defined in section 170 (c). This corresponds to subsection (d) (2) (ii) of the regulations.

Paragraph (5) excepts a power to invade corpus for a beneficiary or beneficiaries. Under subparagraph (A) such a power is excepted if limited by a reasonably definite standard set forth in the trust instrument regardless of whether the beneficiary for whom invasion is permitted is an income beneficiary or a beneficiary of the remainder. Subparagraph (B) excepts a power to invade corpus for a current income beneficiary only, even though no standard is provided, but only to the extent that the distribution is chargeable against the proportionate share of corpus held in trust for the particular beneficiary. This proportionate share limitation is designed to insure that the grantor, through a power to invade corpus, may not in effect have a power to allocate income. The provisions of paragraph (5) are identical with corresponding provisions of the regulations except that in subparagraph (A) there is eliminated the requirement that the standard must consist of the needs and circumstances of the beneficiaries.

Paragraph (6) excepts a power to pay income to a beneficiary currently or to accumulate such income for future disposition to the beneficiary. This exception will apply provided that any income which has been accumulated must ultimately be payable either (A) to the beneficiary from whom disposition is withheld, to his estate, or to his appointees (or alternate takers) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors or the creditors of his estate, or (B) upon termination of the trust or in conjunction with a disposition of corpus which contains the accumulated income, to the current income beneficiaries in irrevocably specified shares. (Under the House bill a general power of appointment was required in the case of this exception but your committee has considered it advisable to restore the rule of the regulations which would include within the exception the case where the beneficiary has a broad special power.) Accumulated income is considered to be ultimately payable in accordance with the foregoing rules even though the trust provides for payment to contingent beneficiaries if the primary beneficiary fails to survive the date fixed for distribution, if such date may reasonably be expected to occur within the lifetime of the primary beneficiary. Accordingly, a grantor is not taxed on the income if he can postpone payment for a reasonable period of time provided the period is not so long that the effect of the power is the same as though it permitted an allocation of income between the income beneficiary and the remainderman. The rules of paragraph (6) are the same as those in the regulations.

Paragraph (7) excepts a power (exercisable only during the disability of a current income beneficiary or during the period during which any income beneficiary is under the age of 21 years) to pay income to such beneficiary or to add the income to corpus. Such a power is excepted even though the accumulated income will not be paid to the beneficiary from whom withheld.

Paragraph (8) excepts a power to allocate receipts or disbursements between corpus and income even though the power is expressed in broad language. Under the House bill this exception was only specifically applicable to "receipts". This exception is designed to insure that a power which is normally vested in the trustee for purposes of conforming to appropriate trust accounting principles may not, if vested in the grantor as trustee, be construed as a power to determine the beneficial enjoyment of income or corpus.

Subsection (c) of section 674 provides a broader exception for powers exercisable by independent trustees. Under this subsection (which corresponds to sec. 39.22 (a)–21 (d) (2) (iii) of the regulations) a power to allocate income or corpus among a class of beneficiaries will not cause the grantor to be subject to tax if the power is held by any person other than the grantor or a person who is both related to the grantor and subservient to his wishes. Under the regulations, such a power would not be excepted from the general rule if held by the spouse of the grantor or (if the power would affect the interests of the wife or a child of the grantor) by any related party. The rule in this section is more liberal in that it attributes the power held by another person to the grantor only if such person is subservient. However, the presumption of subserviency of a related or subordinate party set forth in section 672 (c) is applicable.

Subsection (d) adds an exception not contained in the House bill, but contained in the regulations, under which the grantor will not be subject to tax by reason of a power exercisable by a trustee or trustees, not including the grantor or spouse living with the grantor, which enables the trustee to apportion income among a class of beneficiaries provided that the power is limited by a reasonably definite external standard. While this exception, as in the regulations, does not apply to a power held by the grantor or spouse it does apply if the power is held by any related or subordinate trustee whether or not subservient to the grantor.

Under the House bill the exceptions in subsection (b) (5) and (7) and in subsection (c) are qualified by a proviso that the exception will not apply if any person is enabled to add to the class of beneficiaries except where the action is to provide for after-born or after-adopted children. Since this proviso is equally applicable to the powers in subsection (b) (6) and (d) it has been added by your committee after each of those exceptions. Your committee has also, in the interests of clarity, substituted the words "has a power" for the words "is enabled".

Section 675. Administrative powers

This section corresponds to section 675 of the House bill.

This section corresponds to section 29.22 (a)–21 (e) of the regulations providing in substance that the grantor is taxable on income of a trust where the administrative control of the trust is exercisable primarily for the benefit of the grantor rather than of the beneficiaries. The administrative controls which are considered to be exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) to (4), inclusive, of this section.

Paragraph (1), corresponding to subsection (e) (1) (i) of the regulations, covers a power which enables the grantor or any person to deal with the trust property or income for less than an adequate consideration.

Paragraph (2), corresponding to subsection (e) (1) (ii) of the regulations, covers a power enabling the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or security. This power, however, will not subject the grantor to tax where a trustee, other than the grantor, may, under a general lending power lend to any person without interest or security even though the general lending power permits such loans to the grantor, as well as to other persons. The provision is slightly less restrictive than under the regulations which prohibit the power to be held by the spouse of the grantor and does not exempt the power if it permits loans without adequate interest.

Paragraph (3), corresponding to subsection (e) (1) (iii) of the regulations, subjects the grantor to tax if he has directly or indirectly borrowed the corpus or income and has not completely repaid the loan (including interest) before the beginning of the taxable year. While this rule was absolute under the regulations, under this section the grantor will not be taxed merely by reason of borrowing if the loan provides for adequate interest and adequate security and is made by a trustee other than the grantor or a related or subordinate trustee who is subservient to the grantor.

Paragraph (4), corresponding to subsection (e) (1) (iv), applies to general powers of administration exercisable by a person in a nonfiduciary capacity. Such powers include the power to vote stock of corporations comprising the trust funds and powers to control the investment of the trust funds but only where the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control. Thus, the grantor will only be taxable by reason of a power over investments where investments are those in which the grantor individually and the trust have significant voting control and then only if the power is exercisable in a nonfiduciary capacity, that is, in such a manner as to benefit the grantor individually rather than the beneficiaries of the trust. This paragraph has been revised in order to eliminate the inference in the section as it passed the House that the only investments over which control would be treated as held in a fiduciary capacity are stocks or securities of corporations.

Section 676. Power to revoke

This section corresponds to section 676 of the House bill.

Section 676 is the provision corresponding to section 166 of existing law providing that the grantor is taxable on the income of a trust where either he or any person without adverse interest has the power to revest title to the trust property in the grantor. This provision is slightly modified so as to limit its application in the case of powers exercisable only after the expiration of a period of time. Under existing law the grantor is taxable if the power to revoke is exercisable "at any time". As in the case of a power under section 674, it seems appropriate to correlate the section with the short-term trust provisions of section 673.

Your committee has also specifically added a provision similar to that added in section 674 (b) (2) to insure that the possession of a power after the expiration of the short-term trust period will subject the grantor to tax in the year in which the power is currently exercisable.

Section 677. Income for benefit of grantor

This section corresponds to section 677 of the House bill.

This section also corresponds to section 167 of existing law under which income is taxed to the grantor by reason of a power to vest the income in him or to apply it to his benefit.

A limitation with respect to powers over income or accumulations of income which affect income of a period after the expiration of the period of time specified in section 673 is provided consistent with the treatment in sections 674 and 676. Thus, if a trust provides for the accumulation of income for the benefit of the grantor's son for a period of 10 years and then provides that the income of subsequent years shall or may be paid to or accumulated for the benefit of the grantor, the income of the first 10 years is not taxable to the grantor. The income of the 11th and subsequent years is, of course, taxable to the grantor under the general rule as income which, in the current year, is or may be paid to or accumulated for the grantor (unless any power or provision permitting such disposition is eliminated).

Under existing law, section 167 applies to income which may, in the discretion of the grantor or a nonadverse party, be distributed to the grantor, but not, by its terms, to income which is actually so distributed or required to be distributed. Accordingly, while section 167 (a) (2) has been applied, as in *Helvering* v. *Stuart* (317 U. S. 154), to to tax to the grantor income which the grantor has the power to apply to the discharge of his legal obligations, income which is required to be so applied has been taxed to the grantor under section 22 (a). *Douglas* v. *Willcuts* (296 U. S. 1). Since the two types of trusts have the common characteristic of providing for disposition of income (actual or contingent) to or for the benefit of the grantor, they are both appropriately within this subpart. Accordingly, section 677 is made applicable to mandatory as well as discretionary trusts of the character described.

Section 677 (b) corresponds to section 167 (c) of existing law, relating to powers to apply income to the support of the grantor's dependents. No change in substance is made.

Section 678. Person other than grantor treated as substantial owner

This section, except for the correction of a clerical error, corresponds to section 678 of the bill as it passed the House.

Section 678 sets forth the rules under which a person other than the grantor of a trust may be taxed on its income by reason of a power to acquire the corpus or income of the trust. This provision is operative, for example, in the case of a trust established by a husband for the benefit of his children, but under which the grantor's wife may at any time take the trust property. In such a case the wife, having the power to take the property, is treated as the owner thereof and the income is taxed to her. A liberalizing provision is provided under which a person will not be taxed on income by reason of a power vested in him as trustee to apply such income to the support or maintenance of his dependents, except to the extent that the income is so applied. This provision is consistent with section 167 (c) of existing law (section 677 (b) of the new code) relating to equivalent powers held by the grantor.

Subsection (d) of this section provides that the general rule of the section will not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

SUBPART F—MISCELLANEOUS

Section 681. Limitation on charitable deduction

This section corresponds to section 681 of the House bill.

This section corresponds to subsection (g) of section 162 of the 1939 Code. That subsection was inserted by the Revenue Act of 1950 for the purpose of denying the charitable deduction allowed by section 162 (a) (section 642 (c) under this bill) to certain trusts having "unrelated business income" or which entered into "prohibited transactions" described therein.

Section 681 of the House bill restates section 162 (g) of the 1939 Code, except that in subsection (b) the limitation of the deduction allowable under section 642 (c) is changed to correlate the limitation therein with the charitable deduction allowed to individuals under section 170 (b) of this bill.

Your committee has added an amendment to the House provision which makes it clear that the denial of the unlimited deduction under section 642 (c) will not be applied in certain cases. Your committee has thus provided that paragraph (1) of subsection (c) will not be applied in any case to income attributable to property transferred to a trust created under the will of a decedent dying before January 1, 1951. The amendment further provides that in the case of a trust created by the will of a decedent dying on or after January 1, 1951, if the terms of the will require income to be accumulated pursuant to the mandatory terms of the will creating the trust, the rule of paragraph (1) will apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

Section 682. Income of an estate or trust in case of divorces, etc.

This section is identical with section 682 of the House bill.

This section corresponds to section 171 of the 1939 Code, which provided rules in certain cases for taxing the income of trusts as between spouses who are divorced or legally separated under a decree of divorce or of separate maintenance. The parenthetical clause in subsection (a) makes the provisions of this section applicable to spouses who are separated under a written separation agreement, as well as to those who are divorced or legally separated under a court order or decree. This change correlates the provisions with section 71 of this bill.

Section 683. Applicability of provisions

This section corresponds to section 683 of the House bill with substantial revision.

The provisions of part I of this subchapter are to be applied only to taxable years beginning after December 31, 1953, and ending after the date of enactment of this title. However, the provisions of part I are not applicable in the case of any beneficiary of an estate or trust with respect to amounts paid, credited or to be distributed in any taxable year of the estate or trust to which this part does not apply. For example, if a trust files its return on a fiscal year basis ending June 30, 1954, the provisions of this bill would not apply in determining the amount of income to be included in the gross income of the beneficiary. In such a case the Internal Revenue Code of 1939 shall apply in making such a determination.

Your committee has revised the provisions of the House bill with respect to the application of section 162 (d) (3) of the 1939 Code (relating to the 65-day rule). Thus, under your committee's bill distributions made within the first 65 days of the first taxable year of a trust or an estate with respect to which this part applies will fall within the provisions of the 1939 Code in determining the amount of distributions and the amount includible in the gross income of the beneficiaries for the preceding taxable year. For example, any amount paid, credited, or distributed in the first 65 days of the first taxable year of a trust or an estate to which this part applies will be deemed to have been paid or credited by such trust or estate in the preceding taxable year if section 162 (d) (3) of the 1939 Code so provides.

Part II—Income in Respect of Decedents

Section 691. Recipients of income in respect of decedents

This section, with the exception of a conforming change in subsection (c) (2) (B) and the addition of a new subsection (d), is the same as section 691 of the House bill. The section corresponds to section 126 of the 1939 Code. However, the provisions of the existing law have been revised to incorporate several major changes in its present scope.

Section 126 of the existing law does not apply to cases involving successive decedents. Its provisions were added by the Revenue Act of 1942 and were designed to overcome the preexisting requirement that there be included in the income of a decedent for the taxable period in which his death occurred all the income accrued up to the date of his death, if not otherwise includible in respect of such period or a prior period. In order to overcome the "bunching" of all such income in the decedent's final return, the 1942 amendments made the income accrued solely by reason of the decedent's death taxable to the actual recipient at the time the income was received. However, the hardship caused by the pyramiding of income in the decedent's last return, which the existing provisions of section 126 were designed to eliminate, continues to exist in the case of subsequent decedents. For example, if the widow of a life insurance agent acquires by reason of the death of her husband the right to receive renewal commissions on life insurance sold by him in his lifetime and payable over a period of years, but the widow dies prior to the receipt of such commissions, leaving the right to receive the commissions to her son, no income in respect of the commissions is required to be included in the final return of the husband. However, upon the subsequent death of his widow, the fair market value of the right to receive such commissions must, under the existing law, be included in her final return.

This section amends the provisions of the present law in order to apply the existing principle in the case of one or more subsequent decedents. In order to effectuate this revision, amendments have been made in subsection (a) (1) (corresponding to sec. 126 (a) (1) of existing law) to make it clear that an item of gross income in respect of a subsequent decedent includes an amount which was an item of gross income in respect of a prior decedent, provided the right to receive such amount was acquired by the subsequent decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent. Thus, in the example above, the insurance commissions would be considered an item of gross income in respect of the deceased widow of the insurance agent. Conforming amendments are contained in subsection (a) (2) and (3) of this section (corresponding to sec. 126 (a) (2) and (3)) to provide that the term "transfer" does not include transmission at death to the estate of a decedent oı to a person entitled to receive an amount by reason of the death of a decedent or by bequest, devise, or inheritance by the decedent. Under subsection (a) (3) the character of the income in the hands of whatever recipient is to be determined as if the recipient had acquired the amount in the transaction in which the right to receive the income was originally derived. This makes the existing principle clearly applicable in cases involving successive decedents.

The second major change in the provisions of the existing law is contained in subsection (a) (4) of this section which makes installment obligations items of income in respect of a decedent. This paragraph replaces the provisions of section 44 (d) of the Internal Revenue Code of 1939 insofar as that section applies in the case of installment obligations transmitted at death. The requirement of a bond in such cases has been eliminated and the recipients of payments of installment obligations or the proceeds derived from their sale or satisfaction at other than face value will be taxed in accordance with the provisions of this section. Subsection (a) (4) provides that if an installment obligation was received by a decedent upon the sale or other disposition of property and the income from such sale or other disposition was properly reportable by the decedent on the installment basis (see sec. 453), and the obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (see sec. 453 (d)) shall be considered an item of gross income in respect of the decedent. For the purposes of subsection (a) (2), relating to the amount includible in income upon the transfer of a right to receive an item of income in respect of a decedent, subsection (a) (4) provides that the entire obligation will be considered a right to receive an item of gross income in respect of the decedent, but that the amount includible in gross income under subsection (a) (2) shall be reduced by the basis of the obligation in the hands of the decedent (determined under section 453 (d)). The term "transfer" as used in subsection (a) (2) has been expanded to include the satisfaction of an installment obligation at other than face value.

The provisions of subsection (c) of this section correspond to section 126 (c) of the existing law. However, several changes have been made in these provisions. The first amendment rounds out the basic revision of existing law to make it applicable to successive decedents. The purpose of this amendment is to authorize a deduction in respect of the estate tax imposed not only upon the estate of the immediate decedent, but of any prior decedent. This amendment also reflects the revision in the estate tax law which eliminates the dual tax system involved in the imposition of the basic tax and the additional tax. The second amendment reflected in subsection (c) has been made to coordinate the provisions of this section with the revised rules relating to the income taxation of estates, trusts and beneficiaries. Where an estate or trust includes in its gross income income in respect of a decedent but all or a part of such income is paid, credited, or required to be distributed to a beneficiary of the estate or trust, the deduction allowable on account of the estate tax attributable to such income must be allocated between the estate or trust and the beneficiary. In such cases the estate or trust must compute the deduction allowable to it under this section by excluding from its gross income the portion, if any, of the items of income in respect of a decedent which is paid, credited, or required to be distributed to beneficiaries during the taxable year. Under existing law items of income in respect of a decedent distributed by an estate or trust are ordinarily not includible in gross income of the beneficiary, because such items represent "corpus" as distinguished from "income" in the hands of the estate or trust. However, the revised income tax provisions relating to estates, trusts and beneficiaries generally do not preserve this distinction for income tax purposes of a beneficiary. See sections 641-663, inclusive. In order to reflect the revised approach employed in these sections, the amendment made in subsection (c) has been necessary. This amendment carries the same effective date provisions applicable with respect to the provisions relating to estates, trusts, and beneficiaries. See section 683 (a).

Under the House bill section 72 (j) provided an additional exclusion from the income of the survivor annuitant of a joint and survivor annuity to compensate for the estate tax imposed on the income element in the annuity. Your committee has substituted for section 72 (j) a new subsection (d) of this section. Under subsection (d) where the deceased annuitant died after December 31, 1953, and after the annuity starting date, a portion of the amounts received by a surviving annuitant, during the period of the surviving annuitant's life expectancy, are treated, for purposes of the deduction for estate tax under subsection (c), as though they were amounts of gross income in respect of a decedent under subsection (a). Such amounts accordingly are to be grouped with other items of income under subsection (a) for the purpose of determining the estate tax attributable to each item under subsection (c) (1) (A).

A special computation is required to determine the net value for estate tax purposes under subsection (c) (2) in the case of annuity payments to which subsection (d) is applied. The value of such items is to be computed (A) by determining the excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludible from the gross income of the surviving annuitant during his life expectancy period, and (B) by multiplying this figure by the ratio which the value of the annuity for estate tax purposes bears to the value of the annuity at the date of death of the deceased annuitant. The operation of the rule in subsection (c) (1) (A) and the reference to the surviving annuitants life expectancy in (d) (1) (B) will have the effect of spreading the estate tax attributable to the net value for estate tax purposes of the annuity over the life of the survivor in such a way that it will be fully allowed as a deduction against income if the survivor reaches his life expectancy (determined at the date of death of the deceased annuitant). If the survivor continues to receive the annuity beyond this expectancy period, there is no further deduction under this section. If the survivor dies before this time there is no compensating adjustment .for the unused deduction.

Subsection (d) (3) defines life expectancy period as the period beginning with the first day of the first period for which an amount is received by the surviving annuitant and ending with the close of the taxable year in which his life expectancy terminates. The life expectancy of the surviving annuitant and his expected return under the contract are to be computed with reference to actuarial tables prescribed by the Secretary.

In conformity with the elimination of section 72 (j) reference to such section in section 691 (c) (2) (B) has been omitted.

Section 692. Income taxes of members of the Armed Forces

This section is identical with section 692 of the House bill and corresponds to section 154 of the 1939 Code, relating to abatement of tax of deceased members of the Armed Forces. Under existing law, the provision is applicable only if the decedent dies after June 24, 1950, and before January 1, 1955.

Under this section, no specific termination date is provided and the benefits of the section are available with respect to a decedent dying after June 24, 1950, and during an induction period as defined in section 112 (c), relating to exclusion of certain combat pay of members of the Armed Forces. Except for the termination date, the section is the same as existing law.

SUBCHAPTER K—PARTNERS AND PARTNERSHIPS

Part I—Determination of Tax Liability

Section 701. Partners, not partnership, subject to tax

This section is identical with section 701 of the House bill.

This provision is essentially the same as section 181 of the 1939 Code. It provides that partners are to be liable for income tax only in their separate or individual capacities. Unlike section 181, it expressly states, rather than implies, that the partnership as such is not to be subject to the income tax.

Section 702. Income and credits of partner

This section represents no change in current law and practice. It incorporates provisions of sections 182, 183 (c), 184, 186, and 189 of present law. The provision is substantially the same as section 702 of the House bill, except for minor technical and clarifying amendments.

Subsection (a) requires each partner, in computing his individual tax, to take into account separately his distributive share of certain items of income, deduction, credit, etc., of the partnership. For purposes of applying this subsection, a partner's distributive share of any item is to be computed in accordance with the provisions of section 704.

Paragraphs (1) through (7) of section (a) specifically require conduit treatment with respect to several major items of income, deduction, etc. The first three of such paragraphs provided that each partner shall treat his distributive share of partnership short-term and long-term capital gains and losses, and gains and losses from sales or exchanges of property subject to the provisions of section 1231 (relating to certain property in a trade or a business and involuntary conversions), as though realized by the partner separately. Such gains and losses accordingly are to be added to, or subtracted from, any items of similar character realized by the partner outside the partnership.

Under paragraph (4), each partner will treat as a charitable contribution by him his distributive share of charitable contributions made by the partnership. The partner's distributive share of such charitable contributions will be taken into account in applying, at the individual level, the limitation on charitable deductions.

Under paragraph (5), each partner is credited with his share of any dividends received by the partnership for purposes of determining his dividends received credit, the dividends received exclusion, or the dividends received deduction (in the case of a corporation which is a member of a partnership). A technical amendment by your committee to this provision of the House bill makes clear that only dividends which would qualify for the dividends received credit under section 34 or the dividends received deduction under part VIII of subchapter B are considered as received by the partners separately under this paragraph.

Under paragraph (6), taxes paid or accrued by the partnership to a foreign country or possession of the United States, and with respect to which the foreign tax credit may be claimed under section 901, are attributed to the partners individually, in accordance with their respective share of such taxes. Accordingly, each partner will add his distributive share of such taxes to any similar taxes paid or accrued by him individually. The partner then has the option to apply the total amount of such taxes as a deduction against income, or as a credit against tax, subject to the limitation on the foreign tax credit.

Paragraph (7) treats partially tax exempt interest on obligations of the United States or instrumentalities of the United States as though realized by each partner separately, in accordance with his distributive share of such income.

Paragraph (8) is a "catch-all" provision which authorizes the Secretary or his delegate to prescribe regulations to require each partner to take into account separately his distributive share of any other items of income, gain, loss, deduction, or credit, the character of which would affect the computation of the partner's personal income tax. For example, partnership gain or loss from gambling operations may be required to be segregated in order to permit individual partners to offset personal gambling gains and losses against their shares of such gains and losses realized by the partnership. Similarly, nonbusiness income or loss may be required to be segregated for purposes of applying the net operating loss provisions to the partners separately.

Paragraph (9) provides that the total amount of taxable income or loss, exclusive of items required to be segregated by other provisions of this subsection, shall be attributed to each partner in accordance with his distributive share thereof. In general, the income or loss under paragraph (9) corresponds to the so-called "ordinary" partnership income or loss under the provisions of the 1939 Code.

Subsection (b) contains a "conduit" rule which makes clear that the character of any item realized by the partnership, and included in a partner's distributive share, shall be the same as though he had realized such item directly, rather than through his membership in a partnership, from the source from which it was realized by the partnership and in the same manner.

Subsection (c) relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61 (a), which defines gross income, has been amended by your committee to make clear that a partner's gross income includes his distributive share of partnership gross income. However, under subsection (c), the determination of a partner's share of the gross income of the partnership need not be made annually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as the application of the provision permitting the spreading of income for services rendered over a 3-year period (section 1301), the amount of gross income received from possessions of the United States, and the extended period of limitations applicable to deficiencies where there has been an omission of 25 percent of gross income.

Section 703. Partnership computations

Subsection (a) combines provisions of sections 183 and !89 of the 1939 Code, effecting no change in existing law. It states that the taxable income of a partnership, although not taxable as such, shall be computed in the same manner as the taxable income of an individual, with certain exceptions. The classes of items described in section 702 (a) must be separately stated. In addition, certain deductions which are applicable only to individuals are not allowed in the computation of partnership income. These are the optional standard deduction, the deduction for personal exemptions, the net operating loss deduction, and the itemized deductions for individuals provided in part VII, such as the medical expense deduction.

The House provisions have been amended by your committee to make clear that partnerships shall not be entitled to deductions for taxes paid or accrued to foreign countries or possessions of the United States, or for charitable contributions, since such deductions are taken by the partners individually under section 702.

Subsection (b) requires that all elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. Thus, elections as to methods of accounting, methods of computing depreciation, the use of the installment sales provision, the option to expense intangible drilling and development costs, etc., must be made by the partnership, and must be applicable to all partners equally. An exception is made permitting a separate election by each partner to use his distributive share of taxes paid or accrued by the partnership to foreign countries and possessions of the United States either as a credit or as a deduction. The exception as to foreign taxes does not constitute a change in existing law, although it eliminates a possible interpretation of sections 183 and 186 of the 1939 code which might permit both the credit to the partners and the deduction to the partnership.

Section 704. Partner's distributive share

With the exception of subsection (e), relating to family partnerships, the provisions of this section are new. However, they are substantially in accord with existing practice.

Subsection (a) provides the general rule that a partner's distributive share of partnership income, gain, loss, deduction, or credit, is to be determined by the partnership agreement.

Subsection (b) provides that, where the partnership agreement does not provide specifically for the manner of sharing one or more of the items set forth in section 702 (a) (other than paragraph (9) thereof), then, each partner's distributive share of such item shall be determined in accordance with his distributive share, as prescribed in the partnership agreement, of partnership income or loss, exclusive of the items required to be treated separately. In the case of a partnership where there is a different ratio for sharing income than that applicable for sharing losses, the income ratio shall be applicable if the partnership has taxable income in the particular taxable year, and the loss ratio shall be applicable in any year in which the partnership has a loss.

Subsection (b) further provides that if the principal purpose of any provision in the partnership agreement dealing with a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the partner's distributive share of that item shall be redetermined in accordance with his distributive share of partnership income or loss described in section 702 (a) (9). For example, if the provisions of a partnership agreement allocate all partnership loss on the sale of depreciable property used in trade or business to one partner, or allocate a greater portion of foreign tax payments to one partner while allocating to the other partner or partners an equivalent amount of partnership loss or deduction of a different nature, such provisions may be disregarded if the principal purpose is tax avoidance or evasion. Such items would then be attributed to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or losses generally.

Where, however, a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes. For example, a partnership agreement whereby a member of the firm who is resident in Puerto Rico is to receive a percentage of the income derived from sources within Puerto Rico which is greater than his distributive share of partnership income generally, will be recognized for tax purposes. Similarly, an agreement under which one partner is to receive all the interest income of the partnership from tax exempt bonds, and the other partner is to receive all the dividend income from stock, will be given effect, unless it is a device for the allocation of the interest exemption without any real economic effect on either partner's share of the total partnership income.

The provisions of subsection (c) contained in the House bill have been amended by your committee in several respects. Paragraph (1) retains the rule of the House bill that items of depreciation, depletion, or gain or loss arising with respect to property which has been contributed to the partnership shall be treated in the same manner as though such items arose with respect to property purchased by the partnership. However, paragraph (2), which has been added by your committee, permits the partners to allocate by partnership agreement items of depreciation, depletion, or gain or loss with respect to contributed property in order to reflect the difference between the basis and the value of such property at the time of its contribution to the partnership. In addition, paragraph (3), added by your committee, provides that undivided interests in property which has been contributed to a partnership shall, under certain conditions, be treated as if the property had continued to be held in undivided interests. Subsection (c), as revised, deals only with contributed property. In the case of a transfer of a partnership interest, the treatment of depreciation, depletion, or gain or loss is determined under section 743.

Paragraph (1) provides that, except as otherwise provided in paragraphs (2) and (3), items of income, gain, loss, deduction, or credit arising with respect to property contributed by a partner shall be allocated among the partners in the same manner as similar items arising with respect to property purchased by the partnership. For example, if a partner contributes to a partnership property with an adjusted basis less than its value at the time of contribution, the gain upon the sale of such property by the partnership will, under paragraph (1), be taxable to each of the partners in accordance with his distributive share of gains in the identical manner as if the property had been purchased by the partnership. Depreciation on contributed property will also be allocated among the partners without regard to which partner contributed the property. This treatment was adopted as the general rule in the interest of simplification. While the rule may result in possible detriment (or gain) to noncontributing partners, it should be noted that there will, in general, be a corresponding loss (or gain) to such partners upon sale or disposition of their interest in the partnership.

Paragraph (1) may be illustrated as follows:

Assume that A and B form an equal partnership. A contributes property worth $1,000 with an adjusted basis of $400. B contributes $1,000 in cash. Under the provisions of section 722, the basis of A's partnership interest is $400. The basis of B's interest is $1,000. If the contributed property depreciates at the annual rate of 10 percent, the partnership will have an annual depreciation deduction of $40, which results in a deduction of $20 in computing each partner's distributive share of partnership income. Thus, at the end of the first year, the basis of the contributed property will be $360. If the partnership has no operating income or deductions, each partner will have a loss of $20. A's basis for his interest will be $380 ($400, the original basis of his interest, reduced by the loss of $20). B's basis for his interest will be $980 ($1,000 less than $20).

If the property is sold in the second year of partnership operations for $900, the partnership gain will be $540 ($900, the amount realized, less the basis of $360). Each partner's share of the $540 gain will be $270. If we assume that the partnership engaged in no other transactions that year, each partner will have a capital gain of $270 from the partnership to report. A's basis for his interest will then be $650 (the basis of $380 increased by the gain of $270). B's basis will be $1,250 (the basis of $980 increased by the gain of $270). If the partnership is then liquidated, and its assets consisting of $1,900 in cash are distributed to the partners pro rata, A will have a capital gain of $300 ($950, the amount received, less $650, the basis of the interest). B will have a capital loss of $300 (the excess of B's basis, $1,250, over the amount received, $950).

Under paragraph (2), depreciation, depletion, or gain or loss with respect to contributed property may, if the partners so provide in the partnership agreement, be allocated among the partners in a manner which takes account of the difference between the basis and the fair market value of contributed property at the time of contribution. The appreciation or depreciation represented by the difference between the basis and value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership. Such appreciation or depreciation may also be used to determine the amount of depreciation or depletion with respect to such property allowable to the contributing partner and the non-contributing partners. In any case, however, the total gain, loss, or depreciation allocated to the partners may not differ from the amount of gain or loss realized by the partnership, or the depreciation or depletion allowable to it. The difference between basis and value represents, under the optional treatment provided in paragraph (2), a postponed gain or loss to the contributing partner to be realized by him when such property is sold or which is, in substance, amortized by him annually through the effect or the depreciation or depletion allowances.

Paragraph (2) may be illustrated as follows:

Assume that partners A and B, in the illustration set forth above, agree to attribute the potential gain represented by the difference between the basis and the fair market value of the property contributed to A to the contributor. Since B, who contributed $1,000 in cash, has, in effect, purchased an undivided half interest in the property for $500, and since the property depreciates at an annual rate of 10 percent, B should be entitled to a deduction of $50 per year. But since the partnership is allowed only $40 per year (10 percent of $400), no more than this amount may be allocated to B. Therefore the partners agree that the $40 deduction for depreciation is to be allocated $40 to B and $0 to A, the contributor. At the end of the first year, the basis of the contributed property will be $360. Since the $40 deduction is allocated entirely to B, if the partnership has no operating income or deductions, A will have no gain or loss, and B will have a loss of $40. A's basis for his interest will remain $400. B's basis for his interest will be $960 ($1,000, the original basis of his interest, reduced by the loss of $40).

Assume further that the partners agree that upon a sale of the contributed property, the portion of the proceeds attributable to the excess of its fair market value (as depreciated) over its basis upon contribution (as depreciated) shall result in gain to the contributing partner. If the property is sold in the second year of partnership operations for $900, the partnership gain of $540 ($900, the amount realized, less the basis of $360) must be allocated to the partners under the terms of the agreement. The original fair market value of the property (as depreciated) is $900 ($1,000, original value, less $100, depreciation based on such value). Under the terms of the partnership agreement the difference between the $900 and the basis of the property, $360, or $540, represents the portion of the gain to be allocated to A. None of the gain is allocated to B. (If the property were sold for more than $900, the gain in excess of $540 would be divided between the partners in accordance with their agreement for sharing gains, here, equally. If the property were sold for less than $900, the entire gain would be allocated to A and nothing to B.) If we assume that the partnership engaged in no other transactions that year, A will report a capital gain of $540, and B, no gain or loss. A's basis for his interest will then be $940 ($400, his original basis, increased by the gain of $540). B's basis will be $960 (his original basis of $960 unchanged by any gain or loss). If the partnership is then liquidated, and its assets, consisting of $1,900 in cash, are distributed to the partners pro rata, A will have a capital gain of $10 ($950, the amount received, less $940, the basis of his interest). B will have a capital loss of $10 (the excess of B's basis, $960, over the amount received, $950).

Paragraph (3) provides for a special allocation among the partners of items arising with respect to undivided interests in property contributed by the partners to the partnership. Depreciation, depletion, or gain or loss with respect to such property shall be determined in the same manner as though such undivided interests continued to be held by the partners outside of the partnership. This provision is applicable only in the absence of a partnership agreement providing otherwise, and only with respect to property contributed to a partnership by all of its partners. The relative interests of the partners in the property prior to contribution must be in the same ratio as their interests in the capital and profits of the partnership subsequent to contribution. The rule stated in this paragraph applies both to the case where partners consciously contribute undivided interests to a partnership and to the case where owners of undivided interests in property, by virtue of engaging in business activity, are determined to be a partnership and required to file a partnership information return.

Paragraph (3) may be illustrated as follows:

A and B are tenants in common owning undivided one-half interests in real estate consisting of a factory and the land on which the factory is situated. They each contribute their respective undivided interests in the real estate to a partnership in which the profits are to be divided equally and the assets are to be divided equally on dissolution. It is immaterial whether such a contribution is expressly made in exchange for interests in a partnership, or whether a partnership is held to exist by virtue of the joint conduct of a business by A and B. A's basis for his undivided one-half interest is $4,000, of which $1,000 is allocable to the land and $3,000 to the factory. B's basis for his undivided one-half interest is $10,000, of which $3,000 is allocable to the land and $7,000 to the factory. The partnership agreement contains no provision as to the allocation of depreciation or as to the allocation of gain or loss on a sale of the property by the partnership. The factory depreciates at a rate of 5 percent a year. The annual allowance for depreciation to the partnership of $500 (5 percent of $10,000) will be allocated between the partners by allowing A a deduction of $150 (5 percent of $3,000, his basis for the factory), and by allowing B a deduction of $350 (5 percent of $7,000, his basis for the factory). At the end of the first year of partnership operation, A's basis for his undivided interest in the factory would be $2,850 ($3,000 less $150), and B's basis would be $6,650 ($7,000 less $350).

If the partnership, at the end of the first year's operation, sells the factory and land for $20,000, each partner's share of the gain, would be determined as follows: Since A's share of the proceeds is $10,000, and his basis for the contributed property is $3,850 ($1,000 for the land and $2,850 for the factory), his capital gain from the sale is $6,150. Since B's share of the proceeds is also $10,000, and his basis in the contributed property is $9,650 ($3,000 for the land and $6,650 for the factory), his capital gain is $350.

The allocation thus illustrated under paragraph (3) also applies if the partners contribute to the partnership additional property not held in the form of undivided interests, but only if their interests in partnership profits and capital correspond with their undivided interests in property contributed to the partnership. If, for example, A, by virtue of a further contribution of cash or property to the partnership, is to receive 60 percent of partnership profits, and B, 40 percent, then, in the absence of a specific agreement, the method of allocation with respect to depreciation and gain arising from the real estate, described above, would no longer apply, and such items would be divided in accordance with the division of partnership income and loss generally. Of course, if the partners agree at the time of A's further contribution that depreciation with respect to the real estate will continue to be allocated in the same manner as it was prior to the contribution, and that the gain or loss to each partner upon a sale of such property will be determined in accordance with the basis of A's and B's respective undivided interests, then such an agreement will be given effect under paragraph (2).

Subsection (d) of the House bill provides a limitation on the amount of partnership loss, ordinary or capital, allowable to a partner. A partner's distributive share of such loss will be allowed only to the extent of the basis of his interest in the partnership at the end of the partnership taxable year in which the loss occurred. Under the House bill, the entire loss is to be recognized immediately, and the amount thereof in excess of the basis of the partner's interest was treated as a loan from the partnership to the partner. To the extent that the partner's obligation is canceled by the partnership, section 737 of the House bill provides that the partner will be treated as having received a distribution in money from the partnership.

Your committee has revised subsection (d) of the House bill to provide that any loss in excess of the basis of a partner's partnership interest may be allowed as a deduction only at the end of the partnership year in which the loss is repaid, either directly, or out of future profits.

Subsection (d), as amended, may be illustrated as follows. Assume that a partner has a basis of $50 for his interest, and his distributive share of partnership loss is $100. Under the subsection, the partner's distributive share of the loss would be limited to $50, thereby decreasing the basis of his interest to zero. The remaining $50 loss would not be recognized, unless the partner makes a further contribution of $50. If, however, the partner repays the $50 loss to the partnership out of his share of partnership income for the following year, then the additional $50 loss will be recognized at the end of the year in which such repayment is made.

Subsection (e) contains the family partnership provisions formerly found in sections 191 and 3797 (a) (2) of the 1939 Code.

Section 705. Determination of basis of partner's interest

The provisions of this section in the House bill have been amended by technical changes, and by adding an alternative rule, subsection (b), for determining the bas s of a partner's interest.

While there are no provisions in the 1939 Code analogous to the provisions in th s section, the ru es provided are in accord with existing practice.

Subsection (a) states the general rule for determining the basis of a partner's interest. Paragraph (1) provides that the unadjusted basis of a partner's interest in a partnership shall be determined in accordance with section 722 (relating to contributions to a partnership) and section 742 (relating to transfers of partnership interests). The unadjusted basis so determined is to be increased by any further contributions and by the partner's distributive share of partnership taxable income (including capital gains), his distributive share of any tax exempt receipts of the partnership, and the excess of his deduction for depletion over the basis of his interest in the depletable property. To the extent that a partnership incurs liabilities, each partner will be considered, under section 752, to have made a contribution in money equal to his pro rata share of such liabilities.

Paragraph (2) provides that the basis of a partner's interest is to be decreased (but not below zero) by his distributive share of partnership losses (including capital losses), partnership expenditures which are neither deductible nor chargeable to capital, and by distributions to the partner from the partnership (including the amount of his share of partnership liabilities discharged).

The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners. Thus, a partner's share of nontaxable income (such as exempt income or depletion allowances in excess of basis) is added to the basis of his interest in the partnership so that the benefit of such tax-exempt income will not be lost to the partner. Otherwise, the partner would eventually incur a capital gain with respect to such amounts. Similarly, the partner's share of nondeductible expenditures must be deducted from his basis in order to prevent such amounts from eventually constituting capital loss to him.

Subsection (b) states an alternative rule for the determination of the basis of a partner's interest. It permits the Secretary or his delegate to prescribe the circumstances under which the basis of an interest may be determined without using the profit and loss method provided in subsection (a). Under the alternative method, there would be attributed to each partner a proportionate share of the total basis of the assets of the partnership. This method of determining basis will be suitable primarily for simple partnerships. The alternative rule may also be employed, however, in the case of more complex partnerships, to the extent permitted by regulations. In such cases adjustments would be required in order to yield substantially the same result as the rule stated in subsection (a). For example, adjustments would be necessary to reflect any discrepancy in the basis of the partnership interests as a result of contributed property, transfers of partnership interests, or distributions of property in kind to the partners.

Section 706. Taxable years of partner and partnership

Subsection (a) of the House bill and your committee's bill corresponds to section 188 of the 1939 Code and makes no substantive change. It requires a partner, in computing his individual income tax to include his distributive share of partnership items for any partnership year ending within or with his taxable year. A partnership taxable year shall be determined as though the partnership were a taxpayer.

The provision has been amended by your committee by including a reference to section 707 (c), in order to make clear that payments made to a partner for services or for the use of capital are includible in his income at the same time as his distributive share of partnership income for the partnership year when the payments are made or accrued, namely, in the taxable year of the partner with or within which the partnership year ends.

Subsection (a), as revised by your committee, may be illustrated as follows:

Partner A is on a calendar year while the partnership is on a fiscal year ending June 30. A receives payments regularly during the partnership year ending June 30, 1956, representing a guaranteed salary and guaranteed payments for the use of capital loaned to the partnership. During this partnership fiscal year, half of the total amount paid to him is received between July 1 and December 31, 1955. The other half is received between January 1 and July 31, 1956. The entire amount received is includible in A's return for the calendar year ending December 31, 1956, along with his distributive share of partnership income for the partnership year ending June 31, 1956.

Subsection (b) has also been amended by your committee in order to liberalize the rule stated therein. Under the amended provisions a partnership may change to, or adopt, a taxable year which is the same as that of all its principal partners, without receiving permission of the Secretary or his delegate. It may also change to, or adopt a taxable year of its own selection if the principal partners are on the same taxable year, or simultaneously change to the same taxable year. Similarly, a principal partner may adopt a taxable year the same as that of the partnership without receiving permission. Of course any change of taxable year by a partner would be subject to the law and regulations applicable to changes in taxable years of individuals.

It is recognized that in many cases it will not be practical for all the principal partners to adopt the same taxable year as the partnership, or that it may become necessary for a principal partner to change to a taxable year other than that of the partnership. It is, therefore, provided that a partnership may adopt or change to a fiscal year other than that of all its principal partners, and that a principal partner may change to a fiscal year other than that of the partnership, if a business purpose for the desired change is established to the satisfaction of the Secretary or his delegate.

The term "principal partner" is defined in subsection (b) (3) to include any partner having an interest in partnership profits or capital of 5 percent or more.

Subsection (c) provides rules relating to the closing of the partnership taxable year in the case of changes in the membership of the partnership.

Paragraph (1) provides that, as a general rule, the taxable year of a partnership shall not, unless the partnership agreement otherwise provides, close as the result of the death of a partner, the addition of a new partner, or the liquidation or the sale or exchange of a partner's interest.

Paragraph (2) provides that, in the case of a partner whose entire interest is liquidated, or sold or exchanged, the taxable year of the partnership shall close with respect to such a partner. The partner's distributive share of items described in section 702 (a) with respect to the short partnership taxable year shall be determined under regulations. However, in the case of a partner who dies, the partnership taxable year shall not close with respect to such partner prior to the end of the normal partnership year, unless (1) the deceased partner's interest is liquidated before that date, and (2) the partnership agreement provides that the partnership year will close with respect to the deceased partner on such a liquidation.

The closing of the partnership taxable year under paragraph (2) occurs only in the case of a partner who no longer retains any interest in the partnership. If a partner's interest is merely reduced, the partnership year with respect to that partner will continue. His distributive share of partnership items required to be included by him in accordance with section 702 (a) will be determined by taking into account the fact that his profits interest may have varied during the partnership taxable year.

The application of these provisions in the case of the death of a partner may be summarized as follows. The partnership taxable year will continue to its normal conclusion both for the remaining partners and with respect to the decedent partner. The last return of the decedent partner will include only his share of partnership income for the partnership taxable year ending with or within the last taxable year of the decedent partner. The income of the succeeding partnership taxable year which is attributable to the interest of the decedent in the partnership will be includible in the return of his estate or successor in interest. In general, the same rule applies, except as modified by the partnership agreement, where the interest of the decedent partner in the partnership is liquidated in connection with his death.

If, however, the partnership is terminated, the taxable year of the partnership will close with respect to all the partners. The termination of a partnership is defined in section 708 (b).

Section 707. Transactions between partner and partnership

Subsection (a) provides the general rule that a partner who engages in a transaction with the partnership, other than in his capacity as a partner, shall be treated as though he were an outsider. Such transactions include the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partner to the partnership or by the partnership to the partner. Transactions involving contributions of money or property to the partnership by the partner, or distributions of money or property by the partnership to the partner are not governed by this section.

Subsection (b) provides an exception to the general rule in the case of sales of property between the partnership and a controlling partner which is designed to prevent tax avoidance through the realization of fictitious losses or increasing the basis of property for purposes of depreciation. The provisions of the House bill, however, have been amended by your committee by adopting the rules comparable to those which are applicable in the case of sales of property between corporations and controlling shareholders under sections 267 and 1240.

Under paragraph (1) deductions for losses on the sale or exchange of property, directly or indirectly, between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital or profits interest in such partnership, are disallowed. Similarly, losses from sales of property between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interests are disallowed.

Where a loss is disallowed under paragraph (1), the last sentence of paragraph (1) provides that section 267 (d) shall be applicable as though the loss were disallowed under section 267 (a) (1). Accordingly, when the purchaser of the property with respect to which the loss was disallowed subsequently sells or disposes of such property, gain shall be recognized only to the extent it exceeds the disallowed loss properly allocable to the property.

Paragraph (2) provides that upon a sale or exchange, directly or indirectly, of property, which in the hands of the transferee is depreciable property, inventory, stock in trade, or any other property which is not a capital asset, any gain recognized shall be ordinary gain, if the sale or exchange takes place between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital or profits interest in such partnership, or between two partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital or profits interests in each partnership.

Paragraph (3) provides that for purposes of paragraphs (1) and (2), the ownership of a capital or profits interest in a partnership is to be determined in accordance with the rules relating to the determination of stock ownership provided in section 267 (c) other than paragraph (3) thereof.

Subsection (c) provides a rule with respect to guaranteed payments to members of a partnership. A partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated, to the extent of such amount, as one who is not a partner, and the partnership shall be allowed a deduction for a business expense. The amount of such payment shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income or gain. A partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a fixed payment in that amount.

The House provisions were amended by your committee to accord the same treatment as that provided in the case of guaranteed salaries to payments for the use of capital, to the extent the payments are determined without regard to partnership income. It should be noted that such payments, whether for services or for the use of capital, will be includible in the recipient's return for the taxable year with or within which the partnership year in which the payment was made, or accrued, ends.

Section 708. Continuation of a partnership

This section is essentially the same as section 761 (e) of the House bill with minor additions.

Subsection (a), which has been added by your committee, makes clear that a partnership will be considered as continuing until such time as it is deemed terminated under section 708 (b). Subsection (a) has general application for purposes of subchapter K.

Subsection (b) is, with minor technical changes, essentially the same as section 761 (e) of the House bill. Paragraph (1) provides that a partnership shall be deemed terminated only if no part of the business, financial operations, or ventures of the partnership continue to be carried on by the partners in any partnership, or if, within a 12-month period, there is a sale or disposition of 50 percent or more of the total interest in partnership capital or the total interest in partnership profits.

Paragraph (2) provides rules applicable to mergers or divisions of partnerships. When two partnerships merge or consolidate, the resulting partnership shall be considered a continuation of the original partnership, the members of which own an interest of more than 50 percent in the capital or the profits of the resulting partnership. When a partnership is divided into two or more partnerships, all resulting partnerships shall, for the purpose of applying the general rule for termination of a partnership, be considered a continuation of the partnership existing before the division. However, any o the resulting partnerships whose members had held a combined interest in the original partnership of 50 percent or less in such partnership's capital or profits shall not be treated as a continuation of the original partnership.

Subsection (c) makes clear that termination of a partnership is optional, and that partnerships qualifying under subsection (b) to be terminated may elect, subject to regulations to be prescribed by the Secretary or his delegate, to be considered as continuing in existence.

Part II—Contributions, Distributions and Transfers

SUBPART A—CONTRIBUTIONS TO A PARTNERSHIP

Section 721. Nonrecognition of gain or loss on contribution

This section, which is identical with the House provisions, codifies existing case law and makes clear that no gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property to the partnership in exchange for a partnership interest. This rule is to apply both in the case of a contribution to a partnership in the process of formation, and in the case of contribution to a partnership which is already formed and operating.

Section 722. Basis of contributing partner's interest

This section, which is identical with the House provisions, corresponds to present practice and provides that the basis of a partner's interest acquired in exchange for a contribution of property, including money, to the partnership shall be the amount of the money contributed plus the adjusted basis to the contributing partner of any property contributed.

Section 723. Basis of property contributed to partnership

This provision, which is identical with the House provisions, corresponds to the first sentence of section 113 (a) (13) of the 1939 Code. It provides that the basis to the partnership of property contributed by a partner shall be the adjusted basis of such property in the hands of the contributing partner at the time of the contribution. That portion of section 113 (a) (13) which requires that the basis of contributed property be increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such a transfer has been omitted because no gain or loss is recognized in such a transaction.

SUBPART B—DISTRIBUTIONS BY A PARTNERSHIP

Section 731. Extent of recognition of gain or loss on distribution

This section sets forth the rules for the recognition of gain or loss upon distributions of money and property by the partnership to a partner. Ordinarily, no gain or loss is recognized upon such a distribution.

Where money is distributed, no gain will be recognized to the distributee partner, except to the extent that such distribution exceeds the basis of his interest in the partnership. This rule is in accord with present practice, and is applicable to current distributions as well as distribution in exchange for all or part of the distributee partner's interest (i. e., complete or partial liquidations).

Loss, on the other hand, is to be recognized to the distributee partner only upon the liquidation of his entire interest in the partnership. Loss will be recognized to the partner whose interest is being liquidated to the extent that the basis of his interest exceeds the amount of money received by him (assuming he receives no property).

The treatment in the House provisions of distributions of property was revised to reduce to a minimum the cases involving recognition of gain or loss.

Under subsection (a) (1) of your committee's bill, gain will be recognized to a distributee partner only to the extent that the money distributed exceeds the basis of his interest in the partnership. This rule is applicable both to current distributions and to distributions in liquidation of an interest. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of $8,000 in cash and property with a value of $3,000, no gain is recognized. If $11,000 of cash were distributed, gain would be recognized to the extent of $1,000.

Under subsection (b), loss will be recognized to a distributee partner only if there is a complete liquidation of the partner's interest in the partnership, and if the property distributed consists only of cash, unrealized receivables, or inventory items. In such a case, the amount of the loss recognized shall be the excess of the basis of such partner's interest in the partnership over the amount of any money distributed and the basis to him (which is ordinarily the same as the basis to the partnership) of any unrealized receivables or inventory items. Thus, if a partner whose basis for his partnership interest is $10,000 retires from the partnership receiving $5,000 in cash and property consisting of inventory items with a basis to the partnership of $3,000, a loss of $2,000 will be recognized to the partner. The basis of his interest is first reduced by $5,000 cash. The remaining $5,000 basis for the interest is allocated to the inventory to the extent of $3,000, and

$2,000 is allowed as a loss. If the partner whose interest is liquidated receives any property other than unrealized receivables or inventory items, then no loss will be recognized.

Gain or loss recognized under subsection (a) will be treated as gain or loss from the sale or exchange of the distributee's partnership interest, that is, capital gain or loss.

Subsection (b) provides that, as a general rule, no gain or loss is to be recognized to the partnership as the result of a distribution to a partner of property or money.

Subsection (c) states that the treatment provided in section 731 shall not be applicable to the extent otherwise provided in section 736, which relates to payments to a retiring partner or a deceased partner's successor in interest. For example, payments under section 736 (a) which are not attributable to the retiring or deceased partner's interest in partnership property follow the rules of section 736 (a) rather than section 731.

Subsection (c) further provides that section 731 shall not be applicable to the extent otherwise provided by section 751. It will be observed that section 751 (b) provides for the recognition of ordinary income to the distributee to the extent that money or property is received from the partnership in exchange for his interest in the unrealized receivables or inventory items of the partnership. Section 751 (b) also applies special rules to the distributee if he receives unrealized receivables or inventory items in exchange for his interest in other partnership property.

If the distributee partner is obligated to repay the amount of money or the value of property withdrawn by him from the partnership, the distribution is not subject to the rules of section 731 but is treated as a loan from the partnership in accordance with the provisions of section 707 (a). Where property is distributed and the distributee is obligated to repay its value in money, the transaction is a credit sale by the partnership under that section. To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money. Section 737 of the House bill sets forth in the statute the rules dealing with distributions considered as loans to a partner. This section has been omitted from your committee's bill because of the treatment now provided for losses under section 704 (d). The other principles expressed in section 737 apply automatically under section 707 (a), which treats a partner engaging in a transaction with a partnership, other than in his capacity as a partner, as if he were an outsider.

Section 732. Basis of distributed property other than money.

The provisions of the House bill have been substantially amended by your committee with respect to the determination of the basis of property distributed to a partner.

Subsection (a) prescribes the basis rules for distributions other than in liquidation of a partner's interest. This includes both current distributions, i. e., distributions of earnings, and distributions in partial liquidation of the distributee's interest in partnership capital or profits. This provision differs from the analogous provision in the second sentence of section 113 (a) (13) of the 1939 Code, which provides that the basis of property distributed in kind shall be such part of the basis of the distributee's interest in the partnership as is properly allocable to such property.

Under subsection (a), the unadjusted basis of property received in a distribution by a partnership to a partner, other than in liquidation of his interest, shall be its basis in the hands of the partnership immediately before the distribution. This carry-over basis rule is subject to the limitation provided in subsection (a) (2), which states that the basis of distributed property to the distributee may not exceed the basis of his interest in the partnership (reduced by the amount of any money received by him in the same transaction).

The limitation contained in subsection (a) (2) may be illustrated as follows:

Partner A has a basis of $10,000 for his partnership interest. He receives a distribution, other than in liquidation of his interest, of $4,000 in cash, and property with a basis to the partnership of $8,000. The basis to the partner of the distributed property is $6,000 ($10,000 the basis of his interest, reduced by $4,000, the cash distributed).

Subsection (b) prescribes the basis rules for distributions in liquidation of a partner's interest. The basis to the distributee of property, other than money, distributed to him in liquidation of his interest shall be the basis of his interest in the partnership less any money received by him from the partnership in the same transaction.

Subsection (c) sets forth the method for allocating the basis to be assigned to distributed property in those cases where the carryover basis rule is not applicable. The allocation rules of subsection (c) apply to distributions in liquidation of an interest (subsection (b)) and to non-liquidating distributions subject to the limitation in subsection (a) (2).

Under subsection (c) (1), the basis to be allocated to the distributed property (other than money) is to be first applied to any unrealized receivables (defined in sec. 751 (c)) and inventory items (defined in sec. 751 (d) (2)) distributed by the partnership. In no case, however, may such property take a higher basis in the hands of the distributee than its basis to the partnership immediately prior to distribution. Where the amount of basis to be allocated to the distributed properties, under subsection (c) (1), is less than the total basis of the distributed unrealized receivables and inventory items to the partnership, the allocation is to be made to such properties in proportion to the basis of such properties in the hands of the partnership.

Under subsection (c) (2), any basis not applied to unrealized receivables or inventory items under subsection (c) (1) shall be applied to other partnership properties received in the distribution. The basis shall be allocated to such properties in proportion to their respective bases in the hands of the partnership. If no property other than unrealized receivables or inventory items is distributed in a liquidating distribution, the basis not applicable to such property results in capital loss to the partner.

Subsection (d) provides a special rule for the determination of the basis of distributed property in the case of a partner who acquired all or a part of his interest by transfer, including a transfer by purchase or upon the death of a partner. Under this subsection, the transferee may, in the case of a distribution made within 2 years after the acquisition of such interest, elect, under regulations, to treat as the basis to the partnership of the distributed property the portion of the basis of his interest (acquired by transfer) which is attributable to such property and to property in which he relinquished an interest in connection with such distribution. The special basis provided in this subsection is treated as the basis of the distributed property to the partnership for the purpose of applying the carryover rule in subsection (a), the substituted basis rule in subsection (b), and the allocation rules of subsection (c).

Subsection (e) states an exception to the rules of section 732 in the case of distributions treated as a sale or exchange of property under section 751 (b), relating to unrealized receivables and inventory items.

Subsections (c) and (d) of this section may be illustrated as follows:

The basis to a partner of his interest in the partnership is $17,000. He receives a distribution from the partnership in liquidation of his partnership interest of $2,000 in cash, inventory with a basis to the partnership of $3,000, property A, a capital asset with a basis of $2,000, property B, a depreciable asset with a basis of $4,000.

Under subsection (b), the basis to be allocated to the property is $17,000, the basis of the partner's interest, less $2,000, the money distributed, or $15,000. This amount is allocated first to inventory in an amount equal to its adjusted basis to the partnership. Thus, the basis of the inventory to the distributee partner is $3,000. This leaves $12,000 to be allocated to the capital and depreciable assets in proportion to their adjusted bases to the partnership. Since the basis of property A is $2,000, and that of property B is $4,000, the $12,000 is allocated $4,000 to A and $8,000 to B.

Assume that the retiring partner in the above illustration is a transferee partner who acquired a half interest in the partnership by purchase. At the time he acquired such interest, the partnership inventory had appreciated in value and was worth $20,000. As a result, $10,000 of the amount paid by the transferee for his interest in the partnership was attributable to such inventory. Assume further that the transferee partner's interest is liquidated within 2 years after the purchase and he can show that 60 percent of the partnership inventory present at the time of the transfer is still owned by the partnership. Thus, $6,000 (60 percent of $10,000) is attributable to his interest in such partnership inventory. Under subsection (d), the amount which is attributable to the distributed inventory and to the balance of the partnership inventory in which the retiring partner has relinquished his interest as the result of his retirement, may be treated as the basis to the partnership of the distributed inventory for purposes of applying subsections (a), (b), and (c).

The transferee partner's basis of his interest, $17,000 less cash received, $2,000, or $15,000, will be allocated among the assets received as follows: The basis of the inventory is $6,000, the portion of his basis attributable to inventory owned by the partnership at the time he purchased the interest. This leaves $9,000 to be allocated to the remaining distributed property in proportion to their adjusted bases to the partnership. Since the basis to the partnership of property A is $2,000, and that of property B, $4,000, the $9,000 is allocated $3,000 to A, and $6,000 to B. If the partnership had acquired other inventory subsequent to the purchase of the interest, the basis of such inventory to the distributee would be its basis to the partnership under the rules of section 732 (c).

The regulations may require the application of subsection (d) where there is a distribution to a transferee partner, whether or not made within 2 years after he acquires his interest, if the fair market value of the property (other than money) received by him exceeds 110 percent of its adjusted basis to the partnership at the time the distribution is made. This application of subsection (d) may be illustrated as follows:

Partnership AB owns 2 parcels of land which have a basis to the partnership of $5,000 each and are worth $55,000 each, and depreciable property with a basis and value of $90,000. C purchases A's partnership interest for $100,000, and shortly thereafter the partnership is dissolved. C receives 1 of the 2 parcels of land which had a basis to the partnership of $5,000 and half the depreciable property which had a basis to the partnership of $45,000. If C's basis for his interest, $100,000, were allocated to the properties received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 and the basis of the depreciable property would be $90,000. As a result, C would, in effect, apply as the basis of depreciable property the amount which he had paid for nondepreciable property. To prevent this result, the regulations may require C to allocate to the land that portion of the basis of his interest properly allocable thereto, $55,000. The depreciable property will then take a basis of $45,000.

Section 733. Basis of distributee partner's interest

This provision, which is identical to section 733 of the House bill, prescribes the adjustments to be made in the basis of the interest of a partner receiving a distribution from the partnership. The basis of his interest is to be reduced by the amount of money distributed to him and the amount of the unadjusted basis to him of any property other than money received as a distribution. The method of determining the unadjusted basis of such property is prescribed in section 732.

Section 734. Optional adjustment to basis of undistributed partnership property

Under current practice, a partnership is not permitted to adjust the basis of remaining partnership property after having made a distribution of part of its property to a partner. If, for example, property with a basis of $1,000 to the partnership is distributed to a partner, and the distributee, under section 113 (a) (13) of the 1939 Code, is required to take that property at an unadjusted basis of $600, the assets remaining in the partnership are not increased to prevent the loss of $400 in basis.

Under the provisions of the House bill, the partnership was required to increase the basis of undistributed partnership assets in an amount equal to the excess of the adjusted basis to the partnership of the distributed property over the basis of such property to the distributee partner. Under the House provisions it was impossible for the distributee's basis to exceed the basis to the partnership. Thus, the circumstances under which such an adjustment would have to be made were relatively limited.

Because of the amendments made to section 732 which, in effect, adopt a substituted basis approach on a liquidation of a partner's interest in lieu of the carryover basis approach of the House provisions, there will in virtually every case be a difference between the basis to the partnership of assets distributed in a complete liquidation of a partner's interest and the adjusted basis of such assets to the partnership prior to the distribution.

Subsection (a) sets forth the general rule that there shall be no adjustment to the remaining assets of the partnership as the result of a distribution of property to a partner by the partnership unless the election provided in section 754 to make such an adjustment is in effect.

Where the election provided in section 754 is in effect, however, the basis of the remaining partnership assets is increased under subsection (b) (2) by the amount of any gain recognized by the distributee partners under section 731 (a) (1). The basis of the remaining partnership assets is also increased by any excess of the adjusted basis to the partnership of any property distributed over the basis to the distributee of such property under section 732.

Conversely, under subsection (b) (2) a partnership subject to the election under section 754 must decrease the basis of the remaining partnership assets by the amount of any loss recognized by the distributee partner under section 731 (a) (2). The basis of the remaining partnership assets must also be decreased by any excess of the basis to the distributee of any property distributed to a retiring partner over the adjusted basis of such property to the partnership immediately before the distribution.

It should be noted that an increase in the basis of remaining partnership properties may occur as the result of a distribution which may or may not result in the liquidation of the distributee's interest in the partnership. A decrease in the basis of remaining partnership assets may result only where there has been a distribution in liquidation of a partner's interest.

Subsection (c) is a cross reference to section 755, which sets forth the manner in which the increases or decreases in the basis of the remaining partnership assets are to be allocated among such assets.

Section 735. Character of gain or loss on disposition of distributed property

This section is identical with section 735 of the House bill except for technical changes.

Subsection (a) prevents a partner from realizing a capital gain on the sale of property distributed to him by the partnership, if the sale of such property by the partnership would have resulted in the realization of ordinary income. Similarly, in the case of a loss on the disposition of such distributed property by the distributee partner, such loss will be an ordinary loss. The provision is applicable to two types of property. When a partner receives a distribution of unrealized receivables (as defined in sec. 751 (c)), any gain or loss realized by him on the disposition of such property will be ordinary gain or loss. When a partner receives a distribution of inventory items (as defined in sec. 751 (d) (2)), any gain or loss realized by him on the disposition of such property will be ordinary income or loss if the property is disposed of within 5 years from the date of the distribution. If an inventory item is held beyond that period, capital gain or loss will be realized upon its disposition, if such property is then a capital asset in the hands of such taxpayer.

Subsection (b) sets forth a rule for ascertaining the holding period, for any purpose other than the 5-year rule prescribed in subsection (a), of property distributed to a partner by a partnership. The distributee partner's holding period is to include the holding period of the partnership for such property. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner will also be included.

Section 736. Payments to a retiring partner or a deceased partner's successor in interest

This section provides rules for the treatment of payments made to a retiring partner or to the estate, heir, or other successor in interest of a deceased partner. Several amendments have been made to the House provisions, the most important of which is the elimination of the 5-year limitation on the treatment of such payments as a distributive share of partnership income or a guaranteed payment.

Subsection (a), as revised by your committee, provides that payments in liquidation of the interest of a retiring partner or a deceased partner shall, except for payments described in subsection (b), be treated as a distributive share of partnership income or as a guaranteed payment under section 707 (c). In either case, the amounts subject to subsection (a) will be treated as taxable income to the recipient and will not be taxable to the remaining partners. There is no limitation on the period of time during which such payments may be made. Payments under subsection (a), however, do not include any amounts which are treated under subsection (b) as payments in exchange for an interest in partnership property.

Subsection (b) provides that the portion of the amounts paid which are attributable to the value of the recipient's interest in the partnership property shall be treated as a distribution by the partnership under the general provisions of this subpart with respect to distributions. The amount so treated shall not be treated as a distributive share of partnership income to the distributee, and shall not serve to reduce the amount of the distributive shares of the remaining partners.

Special rules are provided in subsection (b) (2) so as to exclude certain items from the application of subsection (b). Thus, payments for an interest in partnership property under subsection (b) do not include amounts paid for unrealized receivables of the partnership. Also excluded from subsection (b) are payments for an interest in partnership goodwill, except to the extent that the partnership agreement provides for payments with respect to goodwill. Where the partnership agreement provides for payments with respect to goodwill, such payments may not exceed the reasonable value of the partner's share of partnership goodwill.

Payments under section 736 (a), including payments to a retiring or deceased partner's successor with respect to unrealized receivables, are not subject to the rules of section 751 inasmuch as payments described in section 736 (a) are taxable as ordinary income to the recipient. However, where a portion of the amount paid to a retiring partner or deceased partner's successor in interest is attributable to the value of such partner's interest in inventory items of the partnership which have substantially appreciated in value, such payments are subject to section 736 (b) and the rules provided in section 751 (b) will apply.

This section may be illustrated as follows:

Partnership ABC is a personal service partnership and its balance sheet is as follows:

Assets			Liabilities and capital		
	Adjusted basis	Market value		Adjusted basis	Market value
Cash	$13,000	$13,000	Liabilities	$3,000	$3,000
Accounts receivable	0	30,000	Capital:		
Fixed assets	20,000	23,000	A	10,000	21,000
			B	10,000	21,000
			O	10,000	21,000
Total	33,000	66,000	Total	33,000	66,000

Partner A retires from the partnership in accordance with an agreement whereby he is to receive $10,000 a year for 3 years, a total of $30,000, for his partnership interest. The value of A's capital interest in the partnership, for purposes of section 736 (b), is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of fixed assets). The accounts receivable (unrealized receivables) are not included in A's capital interest in the partnership under section 736 (b). Since the basis of A's interest is $11,000 ($10,000, the basis of his capital investment, plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 on the sale of his interest in partnership property. The balance to be received by him, $18,000, constitutes payments under section 736 (a) and is taxable to A as ordinary income.

The $10,000 A receives in each of the 3 years would ordinarily be allocated as follows: $4,000, payments for the capital interest (one-third of the total payment of $12,000 for the capital interest), and the balance $6,000, payments under section 736 (a). Of the $4,000 attributable to A's capital interest, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is return of capital. The partnership will be entitled to a deduction under section 736 (a) (2) of $6,000 during each of the 3 years.

If the agreement between the partners provided for payments to A for 3 years of a percentage of annual income instead of a fixed amount, a portion of each payment, determined under regulations, would be treated as paid for A's capital interest, based upon its $12,000 value at the time of his retirement. The balance would be treated as a distributive share of partnership income to A under section 736 (a) (1).

SUBPART C—TRANSFERS OF INTERESTS IN A PARTNERSHIP

Section 741. Recognition and character of gain or loss on sale or exchange

Except for technical amendments, this section corresponds to the House provision. It provides that the sale or exchange by a partner of his interest in the partnership shall be treated generally as the sale or exchange of a capital asset. Any gain or loss shall be treated as capital gain or loss unless the partnership has unrealized receivables, or inventory items which have substantially appreciated in value, as defined in section 751. If section 751 is applicable, a portion of the gain or loss shall be treated as ordinary income or loss.

Section 742. Basis of transferee partner's interest

Except for technical amendments, this section corresponds to the House provision. It provides that, in general, the unadjusted basis to a transferee partner of an interest in a partnership shall be determined under the basis rules for property provided by part II of subchapter O (sec. 1011 and following). For example, the basis of a purchased interest will be its cost, and the basis of an interest transferred upon the death of a partner will be the fair market value of the interest at death or the optional valuation date.

Section 743. Optional adjustments to basis of partnership property

This section contains several amendments, both substantive and technical, to section 743 of the House bill. Your committee's bill provides that, with certain exceptions, the adjustment to the basis of partnership assets will affect only the transferee partner. In addition, the House provisions with respect to the allocation of basis adjustments among the partnership properties and the manner of electing to make such adjustments (sec. 743 (c) and (d) of the House bill) have been transferred to sections 755 and 754 of your committee's bill.

Subsection (a) states the general rule that the transfer of an interest in a partnership, either by sale or exchange, or as the result of the death of a partner, although affecting an adjustment to the basis of the transferred interest, will not result in an adjustment to the bases of the partnership properties.

Subsection (b) provides, however, that a partnership may elect to adjust the bases of the partnership assets in order to reflect the increase or decrease in the basis of a transferred interest in the partnership. A partnership making this election shall increase the adjusted bases of the partnership properties by the amount by which the basis of the transferee partner's interest in the partnership exceeds the adjusted basis of the transferor's interest immediately prior to the transfer. In the event that the adjusted basis of the transferor partner's interest in a partnership immediately prior to the transfer exceeds the basis of the transferee partner for his interest, then the adjusted bases of the partnership properties shall be decreased by the amount of this excess. Rules relating to the method of making the election and the effect of the election upon subsequent transfers of interests in the partnership are set forth in section 755.

Subsection (b) further provides that, under regulations prescribed by the Secretary or his delegate, increases and decreases in the basis of the partnership assets are to constitute an adjustment affecting the transferee partner only. However, such adjustment shall be allocated among the partners to the extent that the increase or decrease is attributable to the difference between the value and the unadjusted basis to the partnership of contributed property at the time of its contribution. The application of this provision is described below.

Subsection (b) also provides that when an adjustment is made to the basis of depletable property under subsection (b) as the result of a transfer of an interest in the partnership, any future depletion allowance shall be determined separately with respect to the transferee partner's interest in such property.

Subsection (c) provides that the allocation of the increase or decrease in basis provided in subsection (b) among the partnership properties shall be in accordance with the rules set forth in section 755.

The application of subsection (b) may be illustrated as follows:

Assume that partner A dies when the balance sheet of the ABC partnership is as follows:

Assets			Liabilities and capital		
	Adjusted basis	Market value		Adjusted basis	Market value
Cash	$5,000	$5,000	Liabilities	$10,000	$10,000
Accounts receivable	10,000	10,000	Capital:		
Property X (inventory)	20,000	21,000	A	15,000	22,000
Property Y (depreciable asset)	20,000	40,000	B	15,000	22,000
			C	15,000	22,000
Total	55,000	76,000	Total	55,000	76,000

The partnership has made the election to adjust the basis of partnership assets upon transfer of an interest and, therefore, $7,000, the difference between the adjusted basis of A's partnership interest and the value of such interest at death is to be allocated to the basis of partnership assets.

In accordance with section 755, the allocation may be made in a manner which has the effect of reducing the difference between the fair market values and the adjusted bases of the partnership properties, except that adjustments attributable to capital and depreciable assets must be allocated to properties of a like character, and adjustments attributable to other assets, such as inventory or stock in trade, must be allocated to properties of a like character. Applying this rule to the instant illustration, the total amount of appreciation is $21,000 ($1,000 on property X, and $20,000 on property Y). The basis adjustment is $7,000, or one-third of the $21,000 of appreciation. Applying the rule of section 755, $333 (one-third of $1,000, the excess of the market value over the basis of property X) is allocable to property X, and $6,666 (one-third of $20,000, the excess of the market value over the basis of property Y) is allocable to property Y. The amount so allocable constitutes an adjustment with respect to the transferee partner only (assuming that property X and property Y were not contributed to the partnership).

Assume that A's son, M, takes over his father's interest and that following the transfer of the partnership interest, the partnership sells its inventory, property X which has further appreciated in value, for $24,000. Since the basis of such inventory to the partnership is $20,000, there is $4,000 of ordinary income to be allocated to the partners, $1,333 to each partner. The tax positions of B and C remain unchanged as the result of the transfer and each has $1,333 of income to report. M, on the other hand, has additional basis of $333 with respect to the inventory which reduces his gain to $1,000. The amount of gain to each partner is as follows: $1,333 to B, $1,333 to C, and $1,000 to M.

Assume that for the partnership year following the transfer of the partnership interest, the partnership's allowance for depreciation with respect to property Y, which is depreciable at a rate of 10 percent, is $2,000 (or 10 percent of $20,000, the partnership common basis) of which each of the three equal partners would receive the benefit of a depreciation deduction of $667. The tax position of B and C remains unchanged as the result of the transfer, and each will still have an annual deduction of $667. M, on the other hand, has additional basis of $6,667 with respect to Y, the depreciable property, and consequently, an additional depreciation deduction of $667. The depreciation deductions allowable with respect to property Y are as follows: $667 to B, $667 to C, and $1,333 to M.

The same adjustment as that described above would be made if partner A had sold his partnership interest to an outsider for $22,000.

The provision in subsection (b) that the adjustment to the basis of partnership property shall be allocated among the partners, rather than solely to the transferee, to the extent that it is attributable to the difference between the basis of contributed property and its value at the time of contribution may be illustrated as follows:

(1) Assume that A and B form a partnership AB to which A contributes X, a depreciable asset worth $1,000, with an adjusted basis to him of $400. B contributes $1,000 in cash. During the partnership's first taxable year X appreciates in value to $1,200, and A sells his half interest in the partnership to C for $1,100. Under the rule stated in subsection (b) (1), the adjusted basis of the partnership property, $400, will be increased by the excess of the transferee's basis for his partnership interest, $1,100, over the transferor's basis for his interest immediately prior to the transfer, $400. The amount of the increase is $700. Of this amount, only $100 is attributable to the post-contribution appreciation of X. $600 is attributable to the difference between the basis and the value of X at the time it was contributed. Thus, there is a $100 basis adjustment with respect to the transferee only. The remaining $600 is to be allocated among the partners.

Assuming that the partnership has no special partnership agreement with respect to the allocation of gain or loss or depreciation with respect to X, the $600 will simply be added to the basis of the property for the equal benefit of both partners. Thus, if X which now has a basis of $1,000 to the partnership (the original $400 increased by the $600, available to all the partners), is sold for $1,400, the gain of $400 is allocable $200 to B and $200 to C. However, C has a special basis adjustment of $100 which reduces his taxable gain to $100. The gain recognized therefore is $200 to B and $100 to C.

(2) Assume that the original partnership AB had a special agreement with respect to X, stating that upon the sale of property X, gain to the extent attributable to pre-contribution appreciation was to be allocated entirely to the contributing partner A, and that all the depreciation with respect to X while held by the partnership was to be allocable to B. As the result of a sale by A of his interest in the partnership to C, the $100 attributable to post-contribution appreciation would be allocated to the transferee and the $600 attributable to the pre-contribution appreciation would be allocated to the partnership. The $1,000 of basis belonging to the partnership generally (the $400 original basis plus the $600 adjustment under section 743) would now be shared between the partners exactly as under illustration (1) ($500 to each partner) with a special adjustment to the transferee only of $100 additional basis. In effect, the original partnership agreement with respect to X could be said to have allocated X's original basis of $400 entirely to B with nothing to A. As the result

of the purchase by C, however, the $700 added to the basis of X is divided as follows: Of the $600 attributable to pre-contribution appreciation, $500 is allocable to C and $100 to B. Thus B's share of the $1,000 for X is $500 ($400 allocated to him under the partnership agreement, plus $100 resulting from the adjustment) and C's share is $500 (attributable to the pre-contribution appreciation). C has an additional special basis of $100.

In the event of a distribution by a partnership to a transferee partner of property with respect to which the distributee has special transferee basis under subsection (b), such property shall, for purposes of distributions by the partnership, be deemed to have a basis to the partnership equal to the sum of its common basis shared by all partners and its special basis with respect to the transferee only. In the case of a non-transferee partner receiving a distribution of property with respect to which special basis is allocated to a transferee partner, the property will be deemed to have a basis to the partnership consisting only of its common basis shared by all the partners. No special basis allocated to a transferee will be included. A transferee partner receiving a distribution of property in exchange for his interest in like property with respect to which he has a special transferee basis, will be permitted to apply to the property received his special basis with respect to the interest relinquished in such other property. The property in which he has relinquished his interest may remain in the partnership or may be distributed to the other partners.

The above principle may be illustrated as follows: C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset, with a common basis to the partnership of $100 and an additional transferee basis to C of $20, and Y, another depreciable asset, with a common basis of $80 and an additional transferee basis to C of $30. B and C agree that B will receive a distribution of Y, and C will receive a distribution of X without diminishing either partner's relative interest in the partnership. With respect to B, the partnership basis of Y is $80, the common partnership basis. Y will, therefore, continue to have a basis of $80 in B's hands under section 732 (a), which provides for the use of a carryover basis in the case of nonliquidating distributions. With respect to C, however, the partnership basis of X is $150, the common partnership basis of $100, plus C's additional transferee basis of $20 for property X, plus C's additional transferee basis of $30 for property Y, in which he has relinquished his interest.

The requirement that depletion with respect to partnership property the basis of which has been adjusted as the result of a transfer of a partnership interest, is to be determined separately with respect to the transferee's interest in such property may be illustrated as follows:

A and B each contribute $5,000 to partnership AB which purchases oil property for $10,000. Shortly thereafter, oil is discovered and B sells his partnership interest to C for $100,000. The difference between B's and C's basis, $95,000, is allocated to the oil property. A's share of basis with respect to the oil property remains $5,000. C's basis is $100,000—$5,000, his half share of the common partnership basis, plus $95,000, his additional transferee basis. Assume that, at the end of the partnership year, cost depletion with respect to A's half interest which has a basis of $5,000 is $500, and cost depletion with respect to C's half interest with a basis of $100,000 is

$10,000. Under the percentage method, however, A and B would each be entitled to a $7,000 allowance. With respect to A, percentage depletion is greater. A will, therefore, be allowed a deduction of $7,000. With respect to C, cost depletion is greater. C will, therefore, be allowed a deduction of $10,000.

Subpart D—Provisions Common to Other Subparts

Section 751. Unrealized receivables and inventory items

Because of the amendments made to sections 732 (d) and 743 (b), it has been possible to simplify this section by eliminating the complex provisions of subsections (b) and (c) of the House bill. These provisions are no longer necessary since other provisions of your committee's bill, such as section 732 (d) and section 743, insure to a transferee partner his proper basis with respect to partnership property.

Subsection (a) applies only to a transfer of all or a part of a partnership interest. It provides that, to the extent that the money or fair market value of property received by a transferor of such an interest is in exchange for all or a part of his interest in the partnership attributable to unrealized receivables, or inventory items which have substantially appreciated in value, the money or property received shall be considered to have been realized from the sale or exchange of property other than a capital asset and shall result in ordinary income. To the extent this rule is operative, it supersedes section 741 which states that gain or loss on the sale of a partnership interest shall be considered as gain or loss from the sale of a capital asset.

In determining the amount of ordinary income or loss realized by a partner upon the disposition of his interest in such items, a portion of such partner's adjusted basis for his interest in the partnership must be allocated, under regulations, to his share of unrealized receivables or substantially appreciated inventory items. The amount of basis to be so allocated shall ordinarily be his pro rata share of the partnership basis for such property with appropriate adjustments for any special transferee basis with respect to him under section 743 (b). This amount shall be subtracted from the basis of such partner's interest before computing his capital gain or loss on the sale of his interest under section 741.

The House provisions provide for ordinary loss to the partner selling his interest to the extent that any money or property received therefor is attributable to substantially depreciated inventory items. This provision has been omitted in order to simplify the partnership provisions. The deletion of this provision, however, will not prevent a partner whose interest is, in part, attributable to depreciated inventory items from receiving a distribution in kind of his pro rata share of such items, at a carryover basis under section 732 (a). Upon a subsequent sale of such property, the distributee would realize an ordinary loss.

Subsection (b) provides for the treatment of a distribution by the partnership to a partner (1) where the partner receives more than his proportionate share of the value of partnership unrealized receivables or inventory items which have appreciated substantially in value and (2) where he receives a distribution of more than his proportionate share of partnership property other than unrealized receivables or substantially appreciated inventory items. In the case of a distribution to a partner of more than his proportionate share of partnership property other than unrealized receivables and inventory items the partner has, in effect, sold to the partnership his interest in unrealized receivables or inventory to the extent that he relinquished such interest in exchange for other assets in excess of his proportionate share in such other assets. The distributee will realize ordinary income in the amount of the difference between the basis properly allocable to his relinquished interest in unrealized receivables or inventory, and the value of other partnership assets received by him in exchange therefor. The partnership will have capital gain on the difference between the basis properly allocable to the distributed property in excess of the distributee's proportionate share thereof, and the value of the interest in unrealized receivables or inventory relinquished by him.

In the case of a distribution to a partner of more than his proportionate share of unrealized receivables or inventory items, the partnership has in effect sold to the distributee partner an interest in such property to the extent of the excess over his proportionate share therein. The partnership will therefore realize ordinary income in the amount of the difference between the basis of such receivables or inventory items properly allocable to this excess, and the value of the distributee's interest in the other assets of the partnership relinquished in exchange for such unrealized receivables or inventory items. The distributee, on the other hand, will realize capital gain to the extent that the value of unrealized receivables or inventory received by him in excess of his distributive share therein exceeds the basis properly allocable to the interest in other partnership property relinquished by him.

Paragraph (2) of subsection (b) provides two exceptions to the rules stated in paragraph (1) thereof. When a partner receives a distribution of property which he contributed to the partnership, the rules of paragraph (1) shall not be applicable. The distribution will be governed entirely by the rules set forth in subpart B. This exception permits the withdrawal of contributed property by the contributors, either with or without a complete retirement from the partnership, without the tax consequences provided in subsection (b).

Another exception to the rules of subsection (b) is provided in the case of the complete liquidation of the partnership interest of a retiring partner or of a deceased partner. Payments made by the partnership attributable to the retiring or deceased partner's interest in unrealized receivables are governed by section 736 (a), which provides for ordinary income treatment to the recipient. In the case of payments to a retiring or deceased partner's successor in interest, the rules of section 751 (b) apply only with respect to such partner's interest in partnership inventory items.

Subsection (c) is identical with subsection (d) of the House provisions, except that the term "unrealized receivables and fees" as used in the House bill has been shortened to "unrealized receivables." The term "unrealized receivables" is defined in this subsection to include any rights, contractual or otherwise, to payment for goods delivered, or to be delivered, if such payment would be treated as received for property other than a capital asset, or rights to payment for services rendered, or to be rendered. If such rights to payment were previously includible in income under a method of accounting employed by the partnership, then to that extent their value will not constitute "unrealized receivables."

The term "inventory items," essentially the same in scope as the term "inventory or stock in trade" used in the House bill, is defined in subsection (d) to include partnership property of the kind described in section 1221 (1), and any other partnership property which is not a capital asset or depreciable property described in section 1231. The term "inventory items" also includes any other property held by the partnership, which, if held by the partner receiving the distribution or selling his interest, would be considered property described in the preceding sentence.

Partnership inventory or stock in trade shall be considered to have "appreciated substantially in value" if the fair market value of such property exceeds 120 percent of the adjusted basis for such property in the hands of the partnership, and exceeds 10 percent of the fair market value of all partnership property, other than money. Whereas the House test for substantial appreciation required the value of the inventory items to exceed 10 percent of the adjusted basis of all partnership property other than money, your committee's bill has liberalized this test so that the value of inventory items must exceed 10 percent of the fair market value of such partnership property.

The application of section 751 may be illustrated as follows:

(1) Assume that C buys B's interest in a personal service partnership, AB, when the balance sheet of the firm is as follows:

Assets			Liabilities and capital		
	Adjusted Basis	Market Value		Adjusted Basis	Market Value
Cash	$3,000	$3,000	Note payable	$2,000	$2,000
Advances for clients	10,000	10,000	Capital:		
Other assets	7,000	7,000	A	9,000	15,000
Accounts receivable	0	12,000	B	9,000	15,000
	20,000	32,000		20,000	32,000

The price that C pays B for his partnership interest is $15,000, representing C's share in the net assets shown above, including $6,000 for B's interest in accounts receivable. Since the partnership maintains its books on the cash receipts and disbursements method, the accounts receivable are recorded as income only when received.

Under the provisions of section 751 (a), B realizes $6,000 in ordinary income attributable to his partnership interest in "unrealized receivables." Under the provisions of section 742, C's basis for his interest is $16,000 ($15,000, the cash paid, plus $1,000, partnership liabilities assumed by C). If the election provided in section 743 is in effect, C, the transferee, will be treated as having a special basis of $6,000 in the receivables, so that he will realize no income when they are collected. If no election is made, the transferee may, nevertheless, if he receives his share of the receivables in either a current distribution or a liquidation of his interest within 2 years after the purchase of the interest, apply a $6,000 basis to such receivables under section 732 (d).

(2) The manufacturing partnership ABC agrees to liquidate the interest of C, by means of a distribution to him, when the balance sheet of the partnership, prepared on the accrual basis, appears as follows:

Assets			Liabilities and capital		
	Adjusted basis	Market value		Adjusted basis	Market value
Cash	$10,000	$10,000	Current liabilities	$5,000	$5,000
Account receivable	15,000	15,000	Mortgages payable	30,000	30,000
Inventory	30,000	39,000	Capital:		
Capital assets	40,000	46,000	A	20,000	25,000
			B	20,000	25,000
			C	20,000	25,000
Total	95,000	110,000	Total	95,000	110,000

Assume that the value of the property to be distributed to C is $25,000, consisting of $10,000 cash and $15,000 worth of capital assets with a basis to the partnership of $15,000. Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736 (a). Therefore, the entire payment is for an interest in a partnership under section 736 (b), and subject to the rules of section 751.

The partnership has no unrealized receivables, but the dual test provided in section 751 (d) (1) must be applied to determine whether the partnership inventory has appreciated substantially in value. Since the fair market value of the inventory, $39,000, exceeds 120 percent of its adjusted basis (120 percent of $30,000, or $36,000), and also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $100,000, or $10,000), the inventory has substantially appreciated in value.

Under section 751 (b) (1) (B), C, the retiring partner, has received more than his proportionate share of the value of partnership property other than inventory. C has, in effect, sold his proportionate share of substantially appreciated partnership inventory with a basis of $10,000 (one-third of the total partnership basis of $30,000 for inventory) and a value of $13,000 (one-third of its total value, $39,000) thereby realizing ordinary income of $3,000. The partnership (as constituted after the withdrawal of C) is considered to have purchased C's interest in inventory and has a cost basis of $13,000 for such interest in inventory.

If the partnership had used appreciated capital assets to acquire C's interest in such inventory, it would recognize capital gain on the exchange of capital assets for the inventory. The retiring partner would then use as the basis of the capital asset received in exchange for his interest in inventory, the basis which he originally had for the inventory plus the amount of gain recognized under section 751 (b). The exchange of inventory for noninventory assets is thus treated as a sale or exchange of property and is not subject to the distribution rules provided for partnerships.

Section 752. Treatment of certain liabilities

This section corresponds to section 752 of the House provision except for a technical amendment.

Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of encumbered property by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities. Whenever a partner's individual liabilities are increased because of the assumption by him of partnership liabilities, the amount of the increase shall be treated as a contribution of money by the partner to the partnership. Similarly, when the liabilities of the partnership are increased, thereby increasing each partner's share of such liabilities, the amount of the increase shall be treated as a pro rata contribution by the partners, thereby raising the basis of each partner's interest in the amount of his share of the increase.

Conversely, when a partner's personal liabilities are decreased because a portion of them have been assumed by the partnership the amount of the decrease shall be treated as a distribution of money by the partnership to the partner. Similarly, when the liabilities of the partnership are decreased, thereby decreasing each partner's share of such liabilities, the amount of the decrease shall be treated as a pro rata distribution by the partnership, thereby reducing the basis of each partner's interest in the amount of his share of the decrease.

The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.

This section may be illustrated as follows:

If a partner contributes property with basis of $1,000, subject to a mortgage of $500, to a partnership in exchange for a one-half interest in the partnership, the basis of his interest will be $1,000 (the basis of the contributed property) reduced by $250 (the amount of his liability with respect to such property assumed by the other partner), or $750. The contributing partner still remains subject to $250 of his original $500 liability. When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied. Thus, if a partner sells his interest in a partnership for $750 cash and, at the same time, transfers to the purchaser his pro rata share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000, which will be applied against the basis of his interest in order to determine his gain or loss.

Section 753. Partner receiving income in respect of decedent

The House provision has been amended to make clear that all payments to the successor of a deceased partner coming within the provisions of section 736 (a) are to be considered "income in respect of a decedent". Section 753 thus covers payments in the nature of mutual insurance as well as payments attributable to the decedent's interest in the unrealized receivables of the partnership. Thus, while a successor in interest of a decedent partner will be required to include in gross income amounts received from the partnership which are attributable to the value of the decedent's interest in unrealized fees or mutual insurance, the recipient will at the same time receive a deduction for the estate tax paid with respect to the inclusion of such rights to income in the decedent's estate.

The estate or heir of a deceased partner will also be treated as receiving income in respect of a decedent to the extent that amounts are paid to him by an outsider in exchange for his inherent interest in the partnership attributable to the value of the decedent's interest in partnership receivables or for his right to future payments by the partnership.

The provisions relating to income in respect of a decedent are not applicable to a decedent's interest in partnership inventory.

Section 754. Manner of electing optional adjustment to basis of partnership property

This section is analagous to section 743 (d) of the House bill. It applies in the case of a distribution of partnership property under section 734 as well as in the case of a transfer of an interest under section 743. The House provisions applied only in the case of a transfer of an interest.

In order to make the basis adjustments permitted in sections 734 or 743, the partnership must file a statement of election in accordance with regulations. The election, once made, shall apply with respect to all property distributions and transfers of partnership interests taking place in the year with respect to which the election is made and in subsequent partnership years.

The House provision makes such an election irrevocable until the termination of the partnership. Your committee's provision, however, permits the partnership to revoke the election, subject to regulations to be prescribed by the Secretary or his delegate. In a case where the partnership is able to show that the nature of its business has changed in such a manner that the advantage of the optional basis adjustment is outweighed by an increased administrative burden to the partnership, it will be permitted to revoke its election. This situation could arise because of a substantial increase in its assets, a change in their character, or increased frequency of retirements or shifts of partnership interests. The election will not be permitted to be revoked when the purpose of the revocation is to avoid stepping down the basis of its assets upon a transfer or distribution.

Section 755. Rules for allocation of basis

This section corresponds to section 743 (c) and section 734 (b) of the House bill and contains the rules for allocating among the partnership assets basis adjustments to partnership property as the result of a transfer of partnership interests or the retirement of a partner. The House provision requires such allocation to be made in proportions to the relative bases of such assets, but permitted other methods to be used with the Secretary's permission. Your committee's provisions require the allocation to be made in a manner which will reduce the difference between the fair market value and the basis of each asset adjusted. Here, too, other methods of allocation may be used with the approval of the Secretary. In applying the general rule stated in section 755 (a) (1), if there is an increase in basis to be allocated to the partnership assets, the entire adjustment must be allocated only to the assets whose values exceed their bases in proportion to the difference between the value and basis of each. No adjustment is to be made to assets whose bases exceed their values since this would increase, rather than reduce, the difference between their values and their bases.

Subsection (b) provides that to the extent that any increase or decrease in the basis to be allocated to partnership properties is attributable to a distribution of capital assets or depreciable assets by the partnership, or to a gain to a transferor of a partnership interest attributable to assets of this character, the adjustment may be made only to partnership capital assets or depreciable assets. To the extent that the increase or decrease is attributable to a distribution of inventory, receivables, or any other property except capital assets or depreciable assets, the adjustment may be made only to the basis of partnership property other than capital assets or depreciable assets. In a case where the required increase or decrease in basis cannot be made because the partnership owns no property of the character required to be adjusted, then the adjustment must be made when the partnership acquires property of such a character.

In the case where a decrease in the basis of partnership assets is required and the amount thereof exceeds the basis to the partnership of property of the required character, the basis of such partnership property shall be reduced to zero, and the balance of the decrease in basis will be applied to subsequently acquired partnership property of a like character.

PART III—DEFINITIONS

Section 761. Terms defined

This section defines terms used in subchapter K and corresponds to the House provisions, except that subsection (e) of the House bill appears as section 708 of your committee's bill.

In subsections (a) and (b) the terms "partnership" and "partner" are given substantially the same definition as under section 3797 (a) (2) of the 1939 Code. However, the Secretary or his delegate is given the authority to exclude certain unincorporated organizations from the application of all or part of this subchapter at the election of taxpayers having a financial interest in such organization. Unincorporated organizations may be thus excluded only if availed of for purposes of investment, or for the joint production, extraction, or use of property, but not for the purpose of selling services or the property or products extracted. In order for any organization to be so excluded, the members of such an organization, must be able to determine their income without the necessity of computing a partnership taxable income.

The term "partnership agreement" is defined in subsection (c) to include any oral or written modifications of the original agreement which may be agreed to by all the partners, or adopted in any other manner provided by the partnership agreement.

Subsection (d) provides that the term "liquidation of a partner's interest" means the termination of his entire interest in exchange for a distribution from the partnership.

Part IV.—Effective Date for Subchapter

Section 771. Effective date

The analogous section of the House bill provides that the provisions of subchapter K shall be applicable to partnership years beginning after December 31, 1953, except that provisions relating to transfers of interests and property distributions are to be effective only as to transactions occurring after March 1, 1953.

Your committee's bill applies subchapter K, generally, with respect to partnership taxable years beginning after December 31, 1954, and with respect to partner's individual taxable years within or with which such partnership taxable years end. Partnership taxable years beginning before January 1, 1955, and partners' individual taxable years within or with which such partnership taxable years end shall be subject to the provisions of the 1939 Code dealing with partnerships (secs. 113 (a) (13), 181 to 191 (inclusive), and 3797 (a) (2)) and judicial decisions thereunder.

Subsection (b) contains special rules which have been adopted to make certain provisions effective after March 9, 1954, the date the House bill was reported out by the Ways and Means Committee.

Section 706 (b), relating to the adoption of taxable years by partners and partnerships, has been made applicable to any change by either the partnership or a partner to a taxable year beginning after March 9, 1954. It also applies to the adoption by a newly formed partnership of a taxable year beginning after that date.

Section 735 (a), which provides that gain or loss from the disposition by a partner of unrealized receivables and inventory items held by the distributee for less than five years is to be considered ordinary income or loss, is made applicable to property distributed by the partnership after March 9, 1954. It shall not apply in the case of property of such a character distributed to the partners before March 10, 1953, even though disposed of by the partner after that date.

Section 751, which provides for the realization of ordinary income on transfers and distributions which are, in effect, a sale by a partner of his interest in unrealized receivables or appreciated inventory items, shall be applicable to all such transactions occurring after March 9, 1954. Any other sections of this subchapter without which the determinations required under section 751 could not be made, such as section 705, relating to the determination of the basis of a partner's interest, shall, in accordance with regulations be made effective solely for the purpose of applying section 751.

SUBCHAPTER L—INSURANCE COMPANIES

Part I—Life Insurance Companies

The provisions of this part, containing sections 801 to 807, inclusive, conform to the same sections in the House bill except for changes in section 803 (f) and (g), discussed below.

The methods of taxation of life-insurance companies prescribed in this part are in substance the same as in existing law. The general rule, applicable except for the year 1954, provides for the regular corporate tax on the life insurance company taxable income (its net investment income less the reserve and other policy liability deduction and plus the amount of the adjustment for certain reserves). For the year 1954, a low rate tax is imposed on the 1954 life insurance company taxable income (its net investment income plus eight times the amount of the adjustment for certain reserves and minus the reserve interest credit). This method is the same as was applied under existing law for the years 1951, 1952, and 1953.

Section 801. Definition of life insurance company

This section is identical with section 801 of the House bill and is the same as section 201 (b) of the 1939 Code.

Section 802. Imposition of tax

This section is identical with section 802 of the House bill and is the same in substance as section 201 (a) (1) of the 1939 Code, except that it includes the definition of "life insurance company taxable income." Section 201 (a) cross-refers to other sections for the corresponding definitions of adjusted normal-tax net income and adjusted corporation surtax net income.

Section 803. Other definitions and rules

This section corresponds to section 803 of the House bill and to section 201 (c) of existing law setting forth various definitions essential to computing the tax base of a life-insurance company. These definitions are substantially the same as existing law. While this was also the case in the provisions of the section as it passed the House, your committee has in one respect restored the language of existing law to the extent that it was modified in the House bill. This is in connection with the treatment of such items as gross income, interest paid, and taxable income, where existing law refers only to items of income received or items of deductions paid, whereas the House bill uses the phrases "received or accrued" and "paid or accrued." The change to existing law occurs in subsection (f) (1) and (2) and in subsection (g) (1), (2), and (3).

Section 804. Reserve and other policy liability deduction

This section is identical with section 804 of the House bill.

Subsection (a) of this section, defining the reserve and other policy liability deduction, corresponds to section 202 (b) (1) of the 1939 Code. (The special formula in sec. 202 (b) (2), applicable solely to 1949 and 1950, has been eliminated as obsolete.)

Subsection (b) provides for an adjustment in taxable income in the amount of the partially tax-exempt interest allowed as a deduction where such income is used in determining the amount of the reserve and other policy liability deduction for purposes of the surtax. This results in preserving the treatment provided in section 203 (b) of existing law.

Section 805. 1954 life insurance company taxable income

This section is identical with section 805 of the House bill and corresponds, without change in substance, to section 203A of the 1939 Code.

Section 806. Adjustment for certain reserves

This section is identical with section 806 of the House bill. The definition is the same as in section 202 (c) of existing law.

Section 807. Foreign life insurance companies

This section is identical with section 807 of the House bill. The treatment of foreign life insurance companies is the same as is prescribed in section 201 (a) (2) and (3) of existing law.

PART II—MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES)

The provisions of this part, containing sections 821 to 823, inclusive, are identical with the corresponding provisions of the House bill.

Section 821. Tax on mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies)

This section corresponds to section 207 (a) (except par. (5) thereof) of the 1939 Code without change of substance. However, the base upon which the ordinary corporate tax is imposed is described as mutual insurance company taxable income (gross investment income, less certain deductions) which corresponds to the normal-tax net income as defined for purposes of the tax under section 207. Provisions equivalent to section 207 (a) (5), relating to foreign mutual insurance companies other than life or marine, are contained in section 822 (e).

Section 822. Determination of mutual insurance company taxable income

The provisions of this section, containing the method for determining mutual insurance company taxable income, correspond to the provisions of section 207 (b) (1) and (4), (c), (d), (e), and (f) of the 1939 Code.

Section 823. Other definitions

This section contains, without change of substance, the definitions of "net premiums" and "dividends to policyholders" contained in section 207 (b) (2) and (3) of the 1939 Code.

PART III—OTHER INSURANCE COMPANIES

The provisions of this part, containing sections 831 and 832, are identical with the corresponding provisions of the House bill.

Section 831. Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies

This section corresponds, without change of substance, to section 204 (a) (1) and (3) of the 1939 Code. Provisions for the application of the tax to foreign insurance companies, provided in section 204 (a) (2) are contained in section 832 (d).

Section 832. Insurance company taxable income

The provisions of subsections (a), (b), (c) and (e) of this section, relating to the method of computing the taxable income of an insurance company under this part, correspond without change of substance to subsections (b), (c), (e), and (f) of section 204 of the 1939 Code. Subsection (d) corresponds to section 204 (a) (2) and (d) of the 1939 Code.

PART IV—PROVISIONS OF GENERAL APPLICATION

The provisions of this part, containing sections 841 and 842, are identical with the corresponding provisions of the House bill.

Section 841. Credit for foreign taxes

This section, providing for the allowance to an insurance company of the foreign tax credit provided in section 901, corresponds to section 205 of the 1939 Code. No change in substance is made.

Section 842. Computation of gross income

This section corresponds to section 206 of the 1939 Code.

SUBCHAPTER M—REGULATED INVESTMENT COMPANIES

Subchapter M, which includes sections 851 to 855, provides for the tax treatment of regulated investment companies and corresponds to supplement Q of the 1939 Code.

Section 851. Definition of regulated investment company

This section corresponds to section 851 of the House bill except for an amendment to subsection (e), and a conforming amendment to subsection (b). It also corresponds to and is substantially the same as section 361 of the 1939 Code, with certain technical changes introduced for the purposes of clarity and simplification.

Subsection (e) of the House bill, relating to regulated investment companies furnishing capital to development corporations, has been amended by your committee to allow a regulated investment company meeting the requirements of section 851 (e) to include, among its diversified assets, for purposes of section 851 (b) (4) (A) (ii), securities the value of which exceds 5 percent of the value of the total assets of the taxpayer This exception to the general rule applicable to investment companies is available only to the extent that the basis of the securities, when added to the taxpayer's basis for securities of such issuer previously acquired, does not exceed 5 percent of the value of the total assets of the taxpayer at the time of such subsequent acquisition. The exception provided by your committee applies whether or not the taxpayer owns more than 10 percent of the voting stock of the issuing corporation.

Section 852. Taxation of regulated investment companies and their shareholders

This section corresponds to section 852 of the House bill except for clerical amendments to subsection (b).

This section corresponds to and is substantially the same as section 362 (a) and (b) (1)-(7) of the 1939 Code. The provisions have been rearranged and revised.

Section 853. Foreign tax credit allowed to shareholders

This section corresponds to section 853 of the House bill except for a clerical amendment to subsection (a) and a technical amendment to subsection (c), discussed below.

This provision is entirely new and is designed to permit a regulated investment company to elect to be treated as a conduit for the purposes of income, war profits, and excess profits taxes which it pays to foreign countries or possessions of the United States, so that its shareholders may apply their proportionate share of such foreign taxes either as a credit (under section 901) or as a deduction (under section 164 (a)) as if they had paid such foreign taxes.

Subsection (a) provides that in order to make the election, a regulated investment company must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations and must also, for such year, comply with the dividend distribution requirement prescribed in section 852 (a). An investment company, so qualifying, may elect to act as a conduit for the purpose of any income, war profits, and excess profits taxes it pays to foreign countries or possessions of the United States during the taxable year, including taxes which are deemed paid by the shareholder under the provisions of any treaty to which the United States is a party. The conduit treatment provided in this section is not available with respect to the taxes described in section 902 (relating to the credit for corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

Paragraph (1) of subsection (b) provides that an investment company, so electing with respect to a taxable year, shall, for such year, be denied both the deduction (provided in section 164 (a)) and the foreign tax credit (provided in section 901). However, the investment company is allowed to add the amount of such foreign taxes paid to its dividends-paid deduction for that taxable year.

Under paragraph (2) of subsection (b) the shareholder of the investment company making such an election is in effect placed in the same position as persons directly owning stock in foreign corporations. Such shareholder is required to include in his gross income and treat as paid by him, for purposes of the deduction and credit granted in section 164 (a) and section 901, respectively, his proportionate share of such foreign taxes paid. For the purposes of the foreign tax credit provided in section 901, the shareholder must treat as income from sources within foreign countries or possessions of the United States his proportionate share of foreign taxes paid plus the portion of any dividend paid by the investment company which represents income derived from the above-mentioned sources.

Subsection (c) of the House bill has been amended by your committee to provide that the amount to be treated by the shareholder under subsection (b) as his share of foreign taxes or gross income derived from any foreign country or possession of the United States shall not exceed the amount so designated by the company in a written notice to the shareholder mailed not later than 30 days after the close of the company's taxable year. If the company receives income from one or more foreign countries or possessions of the United States, the notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. The subsection, as thus amended, conforms in general to the notice requirements applicable to capital gains dividends under section 852 (c) (3) (C). Under the provision as revised, the shareholder may not claim as his share of foreign taxes paid with respect to any foreign country or possession an amount greater than the amount so designated by the company. If the amount designated by the company exceeds the shareholder's proper share of foreign taxes or gross income with respect to any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

Subsection (d) provides that the election and notice shall be made under regulations prescribed by the Secretary or his delegate.

The application of this section, in the case of dividends paid by a regulated investment company after the close of its taxable year, is subject to the provisions of section 855 (c).

This section may be illustrated as follows:

The X-regulated investment company has total assets, at the close of the taxable year, of $10 million invested as follows:

Domestic corporations		$4,000,000
Foreign corporations in:		
Country A	$3,500,000	
Country B	2,500,000	
		6,000,000
Total assets		10,000,000

The dividend income of X corporation is received from the following sources:

Domestic corporations		$300,000
Foreign corporations:		
Country A	$250,000	
Country B	250,000	
		500,000
Total dividend income		800,000
Taxes withheld by Country A on dividends of $250,000 at a rate of 10 percent	$25,000	
Taxes withheld by Country B on dividends of $250,000 at a rate of 20 percent	50,000	
Total foreign taxes withheld		75,000
Dividend income after foreign taxes withheld		725,000
Operation and management expenses		80,000
Income available for distribution		645,000

X company has 250,000 shares of common stock outstanding and distributes the entire $645,000 as a dividend of $2.58 per share of stock.

The X company meets the 50 percent requirement of section 851 (b) (4) and the distribution requirements of section 852 (a) (1). It notifies each shareholder by mail, within the time prescribed by section 853 (c), that by reason of the election they are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which $0.20 representing taxes paid to country B and $0.10 taxes paid to country A. The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88, $1.80 (which represents such part of the total dividend paid as the foreign dividend income bears to the total dividend income) is to be considered as received from foreign sources. Ninety cents is to be considered as received from country A, and 90 cents from country B.

Section 854. Limitations applicable to dividends received from regulated investment company

This section corresponds to section 854 of the House bill except for technical amendments to subsection (b) (2) and (3), discussed below. The section, for which there is no corresponding provision in the 1939 Code, provides special limitations applicable to the credit under section 34 and exclusion under section 116 for dividends received by individuals, and the deduction under section 243 for dividends received by corporations.

Subsection (a) denies the application of the above-mentioned credit, exclusion, and deduction to a capital-gain dividend (as defined in sec. 852 (b) (3)) received from a regulated investment company.

Subsection (b) (1) limits the amount that may be treated as a dividend for the purposes of the above-mentioned credit, exclusion, and deduction by the shareholder of a regulated investment company, where the investment company receives substantial amounts of income from sources other than dividends (such as interests, etc.). In the case of a regulated investment company, which receives less than 75 percent of its gross income from dividend sources, only the amount of any dividend which bears the same ratio to the total dividend as the dividend income of the investment company bears to its total income may be treated as a dividend for purposes of such credit, exclusion, and deduction.

Subsection (b) (2) of the House bill has been amended by your committee to provide that the amount of any distribution by a regulated investment company which may be treated as a dividend, for the purposes of subsection (b) (1), shall not exceed the amount so designated by the company in a notice to its shareholders mailed not more than 30 days after the close of the company's taxable year. The subsection, as thus amended, conforms in general to the notice requirements applicable to capital gains dividends under section 852 (b) (3) (C) and the treatment of foreign taxes under section 853 (c). Accordingly, in the case of any regulated investment company, a shareholder may not treat as a dividend for purposes of the dividends received credit, exclusion, or deduction the amount of any distribution (whether or not a dividend under sec. 316) except to the extent the company notifies the shareholder, not later than 30 days after the close of the company's taxable year, that the distribution may be so treated as a dividend. If the amount designated by the company should exceed the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount correctly ascertained under section 854 (b) (2).

Subsection (b) (3) (A) provides that the term "gross income," for purposes of this section, does not include gain from the sale or other disposition of stock or securities.

Subsection (b) (3) (B) of the House bill has been amended by your committee to provide that the term "aggregate dividends received" includes only dividends which would qualify for the dividends received credit or exclusion in the hands of a shareholder who is an individual. The rules of section 34 (c) and (d) are therefore made applicable in determining the total dividend income of the investment company. Accordingly, foreign dividends received by an investment company will not be included in the dividend income of the investment company for the purpose of determining whether distributions by the investment company qualify for the dividends received credit, exclusion, or deduction.

For treatment of dividends paid by the regulated investment company after the close of a taxable year, see the provisions of section 855.

This subsection may be illustrated as follows: X investment company, which has complied with the requirements of section 852 (a) pays a dividend of $2 per share for the taxable year ending December 31, 1954. If the aggregate dividends received by the investment company amount to only 60 percent of its gross income, only $1.20 per share (60 percent of the dividend paid) may be taken into account for the purposes of the above-mentioned credit, exclusion, or deduction. Where the aggregate dividends received amount to more than 75 percent of the investment company's gross income, no allocation need be made and the entire dividend may be taken account of by the recipient for purposes of the credit, exclusion, or deduction.

Section 855. Dividends paid by regulated investment company after close of taxable year

This section, which is identical with section 855 of the House bill, provides rules to be applied by the regulated investment company and its shareholders with respect to dividends which the investment company pays after the close of its taxable year.

Subsection (a) corresponds to and is substantially the same as section 362 (b) (8) of the 1939 Code.

Subsection (b) provides that the shareholder of the regulated investment company shall treat the dividends referred to in subsection (a) as received in the taxable year in which the distribution is made. Thus, dividends distributed after the close of the investment company's taxable year are included in the shareholder's income for the shareholder's taxable year in which received even though paid out of the investment company earnings and profits for the prior year.

Subsection (c) provides that, in the case of dividends paid after the close of its taxable year, the notice requirements applicable in the case of capital gains dividends (provided for in sec. 852 (b) (3)), the election with respect to foreign taxes (provided for in sec. 853) and the restrictions pertaining to certain dividends (provided for in sec. 854), may be satisfied if such notice is mailed to its shareholders not later than 30 days after the close of the taxable year in which the distribution is made.

Subsection (d) provides that, in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

SUBCHAPTER N—TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

Part I—Determination of Sources of Income

Section 861. Income from sources within the United States

Section 862. Income from sources without the United States

Section 863. Items not specified in section 861 or 862

Section 864. Definitions

These sections, which are identical with sections 861–864 of the House bill, correspond to section 119 of the 1939 Code. No substantive change is made, except that section 861 (a) (3) would extend the existing 90-day $3,000 rule in the case of a nonresident alien employee of a foreign employer to a nonresident alien employee of a foreign branch of a domestic employer.

Part II—Nonresident Aliens and Foreign Corporations

Subpart A—Nonresident Alien Individuals

Section 871. Tax on nonresident alien individuals

This section corresponds to section 871 of the House bill and to section 211 of the 1939 Code. The House made no substantive change except that: (1) the tax base of nonresident alien individuals not engaged in trade or business in the United States is enlarged to include gains, profits, and income which are considered gains from the sale or exchange of capital assets; and (2) in keeping with the change noted above in section 861 (a) (3), the 90-day $3,000 rule is also applied to the nonresident alien employee of the foreign branch of a domestic employer.

Your committee has revised the first change to restrict its scope to amounts described in section 402 (a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets. Thus, under the section as revised by your committee, the nonresident alien individual not engaged in trade or business in the United States would be taxable on the following additional items: (*a*) Gains derived by an individual from a lump-sum distribution made to him by a qualified pension trust in 1 year on account of his separation from the service of his employer, considered under section 402 (a) (2) to be gains from the sale or exchange of capital assets to the extent that the amount of the distribution exceeds the amount contributed by the employee; (*b*) gains derived from the disposal of timber, coal, or iron, which are considered to be gains from the sale or exchange of capital assets under section 631 (b) and (c) and section 1231; and (*c*) gains derived by an individual from transfer of an interest in a patent, which are considered to be gains from the sale or exchange of a capital asset under section 1235.

This change would not affect existing law in the case of other gains from the sale or exchange of capital assets, such as stocks and securities.

Section 872. Gross income

This section, which is identical with section 872 of the House bill, is, in substance, identical with section 212 of the 1939 Code.

Section 873. Deductions

This section, which is identical with section 873 of the House bill, is, in substance, identical with sections 213 and 214 of the 1939 Code.

Section 874. Allowance of deductions and credits

This section, relating to necessity for filing return by nonresident alien individual in order to secure benefit of deductions and credits, is identical in substance with sections 215 and 216, 3939 Code and corresponds to section 874 of the House bill.

Your committee has revised this section to make it clear that it shall not be construed to deny the credits for tax withheld at the source provided by section 31 (relating to tax withheld at the source on wages), and section 32 (relating to tax withheld at the source on nonresident aliens and on tax-free covenant bonds).

Section 875. Partnerships

This section, relating to tax status of a nonresident alien who is a member of a resident partnership, is substantially identical with section 219, 1939 Code, and is identical with section 875 of the House bill.

Section 876. Alien residents of Puerto Rico

This section, relating to special tax status of a nonresident alien who is a resident of Puerto Rico, is identical in substance with section 220, 1939 Code, and is identical with section 876 of the House bill.

Section 877. Cross reference

This section is identical with section 877 of the House bill.

SUBPART B—FOREIGN CORPORATIONS

Section 881. Tax on foreign corporations not engaged in business in United States

This section corresponds to section 881 of the House bill, relating to foreign corporations not engaged in trade or business in the United States, and is, in substance, identical with section 231 (a), 1939 Code, except that it contains no reference to treaties, and enlarges the tax base of such corporations.

The House bill enlarged the tax base of such corporations to include amounts which are considered to be gains from the sale or exchange of capital assets. Your committee has restricted the scope of this changed to gains derived from the disposal of timber, coal, and iron which are considered to be gains from the sale or exchange of capital assets under section 631 (b) and (c), and section 1231.

Section 882. Tax on resident foreign corporations

Except for a technical change in subsection (c), this section corresponds to section 882 of the House bill.

Subsection (a), relating to method of taxation of foreign corporations engaged in trade or business in the United States, is, in substance, identical with section 231 (b), 1939 Code.

Subsection (b), relating to gross income in the case of foreign corporations, is, in substance, identical with section 231 (c), 1939 Code.

Subsection (c), relating to necessity for filing of returns by foreign corporations in order to secure allowance of deductions is, in substance, identical with sections 232, 233, and 234, 1939 Code.

Subsection (d), relating to return of tax by agent, is taken in substance from section 235 (a), 1939 Code.

Section 883. Exclusions from gross income

This section, relating to exclusion from gross income of foreign corporations of ship and aircraft profits, is, in substance, identical with section 231 (d), 1939 Code, and is identical to section 883 of the House bill.

Section 884. Cross references

This section is identical with section 884 of the House bill.

SUBPART C—MISCELLANEOUS PROVISIONS

Section 891. Doubling of rates of tax on citizens and corporations of certain foreign countries

This section, relating to discrimination in taxation against United States citizens and corporations by foreign countries, is, in substance, identical with section 103, 1939 Code, and is identical with section 891 of the House bill.

Section 892. Income of foreign governments and of international organizations

This section, relating to exemption from United States tax of income of foreign governments and international organizations, is, in substance, identical with section 116 (c), 1939 Code, and is identical with section 892 of the House bill.

Section 893. Compensation of employees of foreign governments or international organizations

This section, relating to exemption from United States tax of the salaries and wages of alien employees of foreign governments and international organizations, corresponds to section 116 (h), 1939 Code and is identical with section 893 of the House bill. No change in substance is intended to be made in the scope of the exemptions accorded by section 116 (h), as in effect at the present time. Thus, to the extent that the exemption provided by section 116 (h) has been modified in the case of alien individuals with immigrant status, by legislation passed subsequent to the enactment of section 116 (h), this section will be deemed subject to such modification.

Section 894. Income exempt under treaty

This section, relating to exclusion from gross income of items of income exempt from tax by treaty, is, in substance, identical with section 22 (b) (7), 1939 Code, and is identical with section 894 of the House bill.

PART III—INCOME FROM SOURCES WITHOUT THE UNITED STATES

SUBPART A—FOREIGN TAX CREDIT

Section 901. Taxes of foreign countries and of possessions of United States

This section corresponds to section 901 of the House bill.

Section 901, relating to credit for income, war profits and excess profits taxes paid or accrued to any foreign country and United States possession, as revised by your committee, is identical in substance to section 131 (a) of the 1939 Code. The House bill would have permitted a taxpayer to credit a "principal tax" paid or accrued to the national government of a foreign country or of a possession of the United States. This change has been eliminated by your committee.

Section 902. Credit for corporate stockholder in foreign corporation

Section 902 (a), (b), and (c), as revised by your committee, is identical in substance to section 131 (f) of the 1939 Code, relating to credit by domestic corporation for income, war profits, and excess profits taxes paid by a foreign corporation to any foreign country or possession of the United States.

The House bill revised the provision for credit to take into account credit for a principal tax. This change has been eliminated by your committee.

Section 902 (d), a new subsection added by the House bill and revised by your committee, relates to the nature of certain payments, made by a wholly owned foreign subsidiary to its domestic parent corporation, for purposes of the foreign tax credit of the domestic parent under section 902.

Subsection (d) provides that, for purposes of this subtitle, if—

(1) a domestic corporation owns, directly or indirectly, 100 percent of all classes of oustanding stock of a foreign corporation which is engaged in manufacturing, production or mining, and

(2) such domestic corporation receives property in the form of a royalty or compensation from such foreign corporation pursuant to a contractual arrangement under which the domestic corporation furnishes services or property in consideration for the property received from the foreign corporation, and

(3) such contractual arrangement provides that the property received by the domestic corporation is in lieu of dividends, and that the foreign corporation will neither declare nor pay any dividends in any calendar year in which such property is paid to the domestic corporation,

then the excess of the fair market value of such property so received by such domestic corporation over the cost to such domestic corporation of the property and services so furnished by such domestic corporation shall be treated as a distribution by such foreign corporation to such domestic corporation. The subsection further provides that, for purposes of section 301, the amount of such distribution shall be such excess, in lieu of any amount otherwise determined under section 301, without regard to section 902 (d); and that the basis of such property so received by such domestic corporation shall be the fair market value of such property, in lieu of the basis otherwise determined under section 301 (d) without regard to this subsection.

Section 903. Principal tax

Your committee has eliminated the concept of "principal tax" embodied in section 903 of the House bill, and has restored in section 903 the provisions of present law contained in section 131 (h) of the 1939 Code.

Section 904. Limitation on credit

Section 904, relating to limitation on the amount of the credit for foreign taxes, corresponds to section 904 of the House bill and to the "per country" limitation in section 131 (b) (1), 1939 Code. The "overall" limitation in section 131 (b) (2) of the 1939 Code is eliminated.

The section limits the amount of credit for taxes paid or accrued to any foreign country or possession of the United States under this subpart to the same proportion of the tax against which such credit is taken, which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

The House bill contained an additional limitation to take into account the 14 percent tax credit allowed a domestic corporation by sections 37 and 923 of its bill with respect to business income from foreign sources. This limitation has been eliminated by your committee to conform to its elimination of such sections from the bill.

Section 905. Applicable rules

This section corresponds to section 905 of the House bill and as revised by your committee, is identical in substance to section 131 (c), (d), and (e) of the 1939 Code. The House bill contained amendments to conform to other provisions of the House bill relating to principal tax. These amendments have been eliminated by your committee to conform to its elimination of provisions for credit for principal tax.

SUBPART B—EARNED INCOME OF CITIZENS OF UNITED STATES

Section 911. Earned income from sources without the United States

This section, which is identical with section 911 of the House bill, relates to exclusion from gross income of earned income derived from sources without the United States by citizens of the United States and is, in substance, identical with section 116 (a), 1939 Code, except that the definition of earned income has been revised to raise the limitation from 20 to 30 percent in a situation where personal services and capital are material income-producing factors.

Section 912. Exemption for certain allowances

This section (which is identical with section 912 of the House bill) relates to exclusion from gross income of allowances in the case of officers and employees of the United States or its Foreign Service and is, in substance, identical with section 116 (j) and (k), 1939 Code.

SUBPART C—WESTERN HEMISPHERE TRADE CORPORATIONS

Section 921. Definition of Western Hemisphere trade corporations

This section, which corresponds to section 921 of the House bill, is, in substance, identical with section 109, 1939 Code, except that a domestic corporation which does all its business in the Western Hemisphere is not disqualified because of incidental purchases elsewhere.

This section, as revised by your committee, provides that for any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the 1939 Code shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

Section 922. Special deduction

This section, which is identical with section 922 of the House bill, provides a special deduction against taxable income for domestic corporations qualifying as Western Hemisphere trade corporations. This special deduction is substantially equivalent to the credit against net income provided in section 26 (i), 1939 Code. The deduction is in an amount computed by multiplying the taxable income of such a corporation (computed without regard to the section) by a fraction, the numerator of which is 14 percent, and the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11. The fraction is the same whether the corporation is subject to the combined normal tax and surtax, or only the normal tax.

SUBPART D—POSSESSIONS OF THE UNITED STATES

Section 931. Income from sources within possessions of the United States

This section, which is identical with section 931 of the House bill, is identical, in substance, with section 251, 1939 Code.

Section 932. Citizens of possessions of the United States

This section, which is identical with section 932 of the House bill, is, in substance, identical with section 252, 1939 Code.

Section 933. Income from sources within Puerto Rico

This section, which is identical with section 933 of the House bill, is, in substance, identical with section 116 (l), 1939 Code.

SUBPART E—CHINA TRADE ACT CORPORATIONS

Section 941. Special deduction for China Trade Act corporations

This section, which corresponds to section 941 of the House bill and to section 262, 1939 Code, allows a corporation organized under the China Trade Act a special deduction in computing its taxable income. The amount of the deduction (formerly a credit against net income) has been revised to an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong which the par value of the shares of stock owned on the last day of the taxable year by (1) persons resident in Formosa or Hong Kong (instead of China as under existing law), the United States, or possessions of the United States, and (2) individual citizens of the United States (but not of China as under existing law), bears to the par value of the whole number of shares of stock of the corporation outstanding on such date. The qualification in existing law that the special credit against net income will not be allowed unless the corporation has distributed a special dividend of a specified nature has been revised to conform to the above change. Also, the definition of China has been deleted.

Your committee has revised section 941 of the House bill so as to include Hong Kong (in addition to Formosa) within its provisions, and to confine the benefit to taxable income from sources within Formosa and Hong Kong (instead of China).

Section 942. Disallowance of foreign tax credit

This section, which is identical with section 942 of the House bill, is identical, in substance, with section 263, 1939 Code.

Section 943. Exclusion of dividends to residents of Formosa or Hong Kong

This section corresponds to section 943 of the House bill and to section 116 (f), 1939 Code, except that, conforming to the changes made by section 941, a resident of Formosa or Hong Kong (instead of China, as under existing law) may exclude from gross income, dividends received from a China Trade Act corporation.

SUBCHAPTER O—GAIN OR LOSS ON DISPOSITION OF PROPERTY

PART I—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

Section 1001. Determination of amount of and recognition of gain or loss

This section corresponds to section 1001 of the House bill which, except for conforming clerical changes, is the same as section 111 of the 1939 Code.

Your committee has made the following two changes in this section:

(1) The general rule in subsection (b) that the amount realized from the sale or other disposition of property is the sum of money received plus the fair market value of property received is qualified by the addition of special rules relating to real property taxes subject to the special treatment under section 164 (d).

(2) A technical amendment has been made to subsection (c) so that the reference to other provisions to determine the extent to which gain or loss shall be recognized will be made only to section 1002.

Section 1002. Recognition of gain or loss

This section corresponds to section 1002 of the House bill and section 112 (a) of the 1939 Code. In general, it provides that the entire amount of gain or loss determined under section 1001 shall be recognized except as otherwise provided in this subtitle. The exception is made in general terms rather than in reference to specific subchapters as in the House bill.

PART II—BASIS RULES OF GENERAL APPLICATION

Section 1011. Adjusted basis for determining gain or loss

This section is identical with section 1011 of the House bill and, except for conforming clerical changes, is the same as the initial sentence of section 113 (b) of the 1939 Code.

Section 1012. Basis of property—cost

This section corresponds to section 1012 of the House bill which, except for conforming clerical changes, is the same as the first clause of section 113 (a) of the 1939 Code. Your committee has added a proviso to the effect that the cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

Section 1013. Basis of property included in inventory

This section is identical with section 1013 of the House bill and section 113 (a) (1) of the 1939 Code.

Section 1014. Basis of property acquired from a decedent

This section is derived from section 1014 of the House bill with some additional substantive changes. It corresponds to section 113 (a) (5) of the 1939 Code providing in substance that the basis of property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent is the fair market value of such property at the date of the decedent's death, or at the optional valuation date under section 811 (j) where such date is elected for purposes of estate-tax valuation.

Under existing law, there is no uniform correlation between section 113 (a) (5) and section 811 of the 1939 Code, relating to property includible in the decedent's gross estate. Section 113 (a) (5) applies basically to property in the decedent's probate estate and includible in his gross estate under section 811 (a). In addition, it applies to property acquired by certain specifically described methods of disposition which are treated as though the acquisition was "by bequest, devise, or inheritance." However, it does not apply to numerous other types of disposition which result in inclusion of the property for estate-tax purposes, such as property transferred in contemplation of death or property acquired by a surviving joint tenant or tenant by the entirety.

This section sets forth in paragraph (9) an additional rule applicable to property acquired from a decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or nonexercise of a power of appointment) if by reason thereof the property is required to be included in determining the value of the decedent's gross estate. Thus all property required to be included in a decedent's gross estate will receive a basis determined under this section either under paragraph (9) or under one of the provisions continued from present law. Some property not required to be included in the decedent's gross estate will receive a basis determined under this section as provided in present law. The general rule is stated in the preamble of subsection (a) as applicable to property in the hands of a person acquiring the property from the decedent or to whom the property passed from the decedent. The rule is subject to the limitation that it shall only apply to property which has not been sold, exchanged, or otherwise disposed of before the decedent's death by the person to whom the property passed from the decedent. Thus, in the case of a transfer in contemplation of death the basis of the property in the hands of the donee who has retained the property until the decedent's death shall be determined under this section. If, however, the donee has disposed of the property prior to such date its basis both in the hands of the donee and the person acquiring it from the donee shall be determined without regard to this section.

Paragraphs (1) to (9) of subsection (b) describe the circumstances under which property is treated as having been acquired or having passed from the decedent. Paragraphs (1) to (8), inclusive, correspond to provisions of existing law. The only change of substance is in paragraph (8) which limits the application of the section in the case of property representing the survivor's interest in a joint and survivor's annuity to property acquired from a decedent dying before January 1, 1954. In the case of decedents dying after such date, the basis shall be determined in a manner consistent with the provisions of section 72, relating to the income-tax treatment of annuities. Your committee separated paragraphs (1) through (9) of subsection (a) of the House bill into a new subsection (b) for greater clarity. The only substantive change in either subsection (a) or paragraphs (1) through (8) of subsection (b) is the correction of a typographical error in paragraph (5) by changing "August 6" to "August 26".

Paragraph (9) has been substantially revised by your committee. It has been made clear that this paragraph does not apply to property described under any other paragraph. Thus the special basis rules prescribed in paragraphs (5) and (7) will continue to apply in the case of decedents dying after December 31, 1953, as well as the general rules set out in other paragraphs (except where the paragraph is specifically made inapplicable after a certain date). In the case of property acquired before the death of the decedent to which paragraph (9) applies, the basis is the value at the applicable valuation date reduced by the deductions allowed to the taxpayer for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Although the alternate valuation date is applicable, under this rule the taxpayer's basis would be the value on the valuation date less the specified deductions before the decedent's death and this basis will be applicable from the date of the decedent's death. This paragraph does not apply to property acquired from a nonresident not a citizen of the United States unless the property is located in the United States since the property not within the United States is not required to be included in computing the value of the decedent's gross estate. This paragraph will also not affect property acquired for less than full and adequate consideration to the extent the property is regarded as being acquired for full and adequate consideration. The taxpayer's basis will thus never be less than his cost (less adjustments to basis) although in the case of property acquired by gift the basis may be reduced to zero.

Subsections (b) and (c) of the House bill have been redesignated as subsections (c) and (d), respectively. Subsection (c) of your committee's bill provides that this section shall not apply to property which constitutes a right to receive an item of gross income in respect of a decedent to which section 691 applies. This subsection makes explicit the rule of existing law. Subsection (c) of your committee's bill provides that this section shall not apply to restricted stock options described in section 421 where the option has not been exercised by the employee at his death.

Section 1015. Basis of property acquired by gifts and transfers in trust

This section is identical with section 1015 of the House bill. Except for conforming clerical changes, subsection (a) is the same as section 113 (a) (2) of the 1939 Code, subsection (b) is the same as section 113 (a) (3) of such Code and subsection (c) is the same as section 113 (a) (4) of such Code. No substantive change is made.

Section 1016. Adjustments to basis

This section corresponds to section 1016 of the House bill and is derived from section 113 (b) of the 1939 Code. A number of new provisions were added in the House bill necessitated by changes made elsewhere in the proposed new code. Two of such provisions, paragraphs (14) and (16), relating respectively to mortgage foreclosures and to soil and water conservation expenditures, have been deleted by your committee in view of the elimination of section 1035 and in view of the elimination of those provisions in section 175 (relating to soil and water conservation expenditures) which required adjustments to basis even though the taxpayer treated the expenditures as expenses not chargeable to capital account. Your committee has also amended paragraph (15) (redesignated par. (14)) to limit the adjustment for amounts allowed as deductions under section 174 relating to research and experimental expenditures, to expenditures under section 174 (b) (1). Your committee has also added a new paragraph (15) providing for adjustment for deductions disallowed under section 272 relating to the disposal of coal and iron ore.

The new sentence in paragraph (2) which refers to the situation where no method of depreciation is used, is necessary to determine under what method of depreciation the depreciation allowable will be computed. If the taxpayer has not taken a depreciation deduction (either in the current year or for any prior year) the adjusted basis of the property shall be determined by using the straight-line method of depreciation. If the taxpayer, however, has taken a deduction for depreciation, under one of the methods provided in section 167 for 1 or more years but has omitted the deduction in other years, the adjustment for the depreciation allowable in such a case will, of course, be the deduction under the method which was used by the taxpayer. Thus if A has property on which he took a depreciation deduction computed under the method described in section 167 (b) (2) (the declining-balance method) for the first year of its use but did not take a deduction in the second and third years of the assets life, the depreciation allowable for the second and third year will be computed under the declining-balance method. Likewise, if A did not take a depreciation deduction for the first 2 years and then began taking a deduction under the declining-balance method the adjustment to the assets basis for the first 2 years will be under the declining-balance method. If, however, A took varying deductions under no method of depreciation in several years which were allowed on his return and no deductions in other years the adjustment to the properties basis will be made for the depreciation allowed under the varying deductions but for the years in which no deduction was taken the adjustment will be made under the straight-line method.

Section 1017. Discharge of indebtedness

This section is in substance the same as section 1017 of the House bill which, except for conforming clerical changes and deletions of the reference to corporations necessitated by the change made in section 108 (a), is the same as section 113 (b) (3) of the 1939 Code. Insofar as the section refers to income with respect to which basis must be reduced, the reference to section 108 has been changed to section 108 (a) inasmuch as this section does not apply to amounts excluded from income under section 108 (b).

Section 1018. Adjustment of capital structure before September 22, 1938

This section is identical with section 1018 of the House bill and, except for conforming clerical changes, is the same as section 113 (b) (4) of the 1939 Code. No substantive change is made.

Section 1019. Property on which lessee has made improvements

This section is identical with section 1019 of the House bill and, except for conforming clerical changes, is the same as section 113 (c) of the 1939 Code. No substantive change is made.

Section 1020. Election in respect of depreciation, etc., allowed before 1952

This section is identical with section 1020 of the House bill and, except for conforming clerical changes, is the same as section 113 (d) of the 1939 Code. No substantive change is made.

Section 1021. Sale of annuities

This section is identical with section 1021 of the House bill. It has no corresponding section in present law. It integrates the new method for determining the taxable portion of an annuity (provided in sec. 72) with the determination of basis on sale of an annuity contract. Under the general provisions of section 1221, an annuity contract will ordinarily qualify as a capital asset. Tax-free recoveries, which would be subtracted from basis, may for the long-lived annuitant exceed the investment in the contract. This section provides that the basis of the contract shall not be less than zero.

Section 1022. Cross-references

This section, like the same section of the House bill, contains cross-references. The references in paragraph (1) referring to certain corporate distributions has been changed from section 301 (b) (2) to section 301 (c) (2).

Part III—Common Nontaxable Exchanges

Section 1031. Exchange of property held for productive use or investment

This section corresponds to section 1031 of the House bill. Subsection (a) is the same as section 112 (b) (1) of the 1939 Code. Subsection (c) corresponds to section 112 (c) (1), and subsection (c) corresponds to section 112 (e). Your committee has made conforming references in both of these subsections to section 1036 which was added to the bill.

Subsection (d) corresponds to section 113 (a) (6) of the 1939 Code. However, your committee has added the second sentence of such subsection which was omitted in the House bill. Your committee has also omitted the phrase "decreased in the amount of loss" recognized to the taxpayer since subsection (c) provides that no loss may be recognized.

Section 1032. Exchange of stock for property

This section, relating to the exchange by a corporation of its stock for property, except for a change in cross-reference, corresponds to section 1032 of the House bill. It has no counterpart in existing law. Under present law, whether the disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends, under certain decisions, upon whether the transaction constitutes the dealing by a corporation in its own shares which is to be ascertained from all of the facts and circumstances. The purpose of this section is to remove the uncertainties of present law.

Subsection (a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

In section 362 (a) (2), referred to in subsection (b), it is provided that the basis of property acquired by a corporation in certain exchanges for its stock shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor upon such transfer.

Section 1033. Involuntary conversions

This section corresponds to section 1033 of the House bill which reenacted section 112 (f) of the 1939 Code with one substantive change.

Section 1033 (b) extends the provisions of the section to property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of the residence occurred after 1953.

Your committee has added a new subsection (d) to treat as an involuntary conversion a sale or disposition of property lying within an irrigation project if such sale or disposition is made in order to conform to the acreage limitations of the Federal reclamation laws.

Section 1034. Sale or exchange of residence

This section is identical with section 1034 of the House bill.

This section is derived from section 112 (n) of existing law, which provides for nonrecognition of gain where a taxpayer sells his principal residence and purchases and occupies another within one year before or after the sale. The gain is recognized only to the extent that the selling price of the old residence exceeds the cost of the new one. Four substantive changes have been made in this section as it appears in this code.

In subsection (b) the definition "adjusted sales price" has been substituted for the existing term "selling price." Adjusted sales price is defined as the amount realized, reduced by the aggregate of the expenses for work performed on the old residence, in order to assist in its sale, during a 90-day period prior to the contract of sale, which are paid for within 30 days after the date of sale and which are not otherwise allowable as deductions or taken into account in computing gain.

Both under existing law and the new code, selling expenses are deducted from the selling price in determining the "amount realized" on the sale. Thus, this revised definition has the effect of permitting both the selling expenses (including a broker's commission) and the cost of "fixing up" the old residence for purposes of sale to be subtracted from the sales price in computing gain on the sale of the old residence. The definition realistically recognizes that what the seller actually receives on the sale of the old residence is the net proceeds of sale (less the "fixing up" expenses) rather than the nominal selling price. The basis of the new residence will, where applicable, be adjusted by this amount rather than, as formerly, the selling price.

In subsection (h) it is provided that the replacement period shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence and during an induction period, except that any such period as so suspended shall not extend beyond the date 4 years after the date of the sale of the old residence. This is a slight change from section 112 (n) (8), which provides that such period is suspended while the taxpayer is on such duty after the date of sale and before January 1, 1954. Your committee has eliminated the cutoff date of January 1, 1954, thereby permitting suspension of the statute where active duty continues beyond this date, although the requirement that any such period of suspension shall not extend beyond a date 4 years from the date of the sale of the old residence has been retained.

Subsection (i) provides that this section shall be inapplicable to the involuntary conversions of personal residences occurring after December 31, 1953. An involuntary conversion is defined as the destruction, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. This section will continue to apply to all sales or exchanges of personal residences which do not constitute such an involuntary conversion; if a residence is so involuntarily converted, the taxpayer will have the privilege under section 1033 (a) (3) (B) (ii) of applying to the Secretary or his delegate for a longer replacement period in the same manner as taxpayers possessing other types of involuntarily converted property, since section 1033 (formerly sec. 112 (f)) has been made applicable to such conversions of personal residences.

Section 1035. Certain exchanges of insurance policies

This section corresponds to section 1036 of the bill as passed by the House, but your committee has made significant changes. A provision has been inserted in subsection (a) (2) limiting the nonrecognition of gain or loss on the exchange of one endowment insurance contract for another to instances where payments under the contract obtained begin no later than they would have begun under the contract exchanged. Secondly, the word "ordinarily" has been inserted in the definition of a life-insurance contract in subsection (b) (3) to include as life insurance and not as an endowment those contracts which, although in other respects not considered as payable to the insured during his lifetime, may become payable to a very long lived insured when he reaches such an advanced age. Finally, your committee has stricken subsection (c), relating to basis, in its place adding a cross-reference to section 1031 (d) for rules relating to the basis of property acquired in an exchange described in subsection (a), and has eliminated the cross-reference to rules relating to exchanges involving an assumption of liability or property burdened with an assumption of liability.

The section provides that exchanges of life insurance, endowment or annuity policies for such policies shall be tax-free, except that the exchange of an endowment for a life-insurance policy, or of an annuity for a life-insurance or endowment policy, will continue, as under existing law, to be considered a taxable exchange.

Subsection (b) includes a definition of each of the three types of contracts inasmuch as the section draws a statutory distinction between life insurance, annuity, and endowment contracts.

Section 1036. Stock for stock of the same corporation

This section which is not contained in the House bill, is the same (except for certain cross-references in subsection (b)) as section 112 (b) (2) of the 1939 Code.

PART IV—SPECIAL RULES

Section 1051. Property acquired during affiliation

This section corresponds to section 1051 of the House bill and to section 113 (a) (11) of the 1939 Code. In the House bill certain changes from existing law were required by reason of the codification of the consolidated return regulations in chapter 6. Since your committee has in general restored existing law with respect to consolidated returns, it has also restored the substance of existing law in this section.

Section 1052. Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939

This section, except for a technical change in subsection (c), corresponds to section 1052 of the House bill. Subsection (a) is derived from section 113 (a) (12). Subsection (b) is derived from section 113 (a) (16). Subsection (c) is new. If property was acquired before the effective date of the new code, the basis of the property will not be affected by the transition from the 1939 Code to the new code. In the case of provisions of the 1939 Code which are incorporated in the new code, where there is no specific reference in a particular section to acquisitions in taxable years before the effective date of the new code, section 7807 will require the basis to be the same as the basis provided under prior law. In the case of provisions of the 1939 Code which have no corresponding provision in the new code, it is specifically provided here that the basis in taxable years under the new code shall be the basis prescribed in the 1939 Code.

Section 1053. Property acquired before March 1, 1913

This section is identical with section 1053 of the House bill and except for conforming clerical changes is the same as section 113 (a) (14) of the 1939 Code. No substantive change is made.

Section 1054. Cross-references

This section containing cross-references is identical with section 1054 of the House bill.

PART V—CHANGES TO EFFECTUATE FCC POLICY

Section 1071. Gain from sale or exchange to effectuate policies of FCC

This section is identical with section 1071 of the House bill. Except for conforming clerical changes subsection (a) is the same as section 112 (m) of the 1939 Code. Subsection (b) is a cross-reference to the appropriate basis provisions.

It should be noted that this provision deals with changes in the ownership or control of "radio broadcasting" stations. The term "radio broadcasting" as used in this bill and the 1939 Code has an established meaning in the industry and in the administration of the Federal Communications Act which is sufficiently comprehensive to include telecasting.

PART VI—EXCHANGES IN OBEDIENCE TO SEC ORDERS

Section 1081. Nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC

This section is identical with section 1081 of the House bill which, except for conforming clerical changes, is the same as section 371 of the 1939 Code.

Section 1082. Basis for determining gain or loss

This section is identical with section 1082 of the House bill and is the same as section 372 (except subsection (a) (3) which is the same as section 113 (a) (17)) of the 1939 Code.

Section 1083. Definitions

This section is identical with section 1083 of the House bill which, except for conforming clerical changes, is the same as section 373 of the 1939 Code.

PART VII—WASH SALES OF STOCK OR SECURITIES

Section 1091. Loss from wash sales of stock or securities

This subsection is identical with section 1091 of the House bill. Subsections (a), (b), and (c) are the same as subsections (a), (b), and (c), respectively, of section 118 of the 1939 Code. Subsection (d) corresponds to section 113 (a) (10) of the 1939 Code.

SUBCHAPTER P—CAPITAL GAINS AND LOSSES

PART I—TREATMENT OF CAPITAL GAINS

Section 1201. Alternative tax

This section corresponds to section 1201 of the House bill and is derived from section 117 (c) of present law which provides the alternative tax on capital gains. No substantive change is intended, although in the interest of simplification the computation of the alternative tax is described in two steps rather than three. The section differs from section 1201 of the bill as passed by the House in that it is specifically provided that any effects of section 21, relating to changes of rates during a taxable year, are to be disregarded. Therefore, the alternative tax rate under the proposed code for taxable years beginning before April 1, 1954, will be 26 percent regardless of the fact that the year ends after April 1, 1954.

Section 1202. Deduction for capital gains

This section corresponds to section 1202 of the bill as passed by the House except that reference is made to section 662 in addition to section 652, relating to inclusions of amounts in gross income of beneficiaries of trusts. The section is derived from section 117 (b) and in part from section 23 (ee) of present law with no change in substance intended.

Part II—Treatment of Capital Losses

Section 1211. Limitation on capital losses

This section corresponds to section 1211 of the bill as passed by the House except that reference to the deductions of section 151, relating to personal exemptions, has been enlarged to include any deductions available in lieu thereof in respect to the deduction for trusts and estates under section 642 (b). The section is derived from section 117 (d) of present law with no substantive change intended.

Section 1212. Capital loss carryover

This section corresponds to section 1212 of the bill as passed by the House. The section is derived from section 117 (e) of present law which provides a carryover of net capital loss.

A clarifying amendment has been made to the House bill which restates the rule provided in section 322 (d) of the Revenue Act of 1951 by specifying that a capital loss for a taxable year beginning before October 20, 1951, is to be determined under the applicable law relating to the computation of capital gains and losses in effect before that time. No substantive change from present law is intended.

Part III—General Rules for Determining Capital Gains and Losses

Section 1221. Capital asset defined

This section corresponds to section 1221 of the House bill and is derived from section 117 (a) (1) of present law which provides that a capital asset is property held by the taxpayer with certain exceptions. The only substantive change intended is the insertion of a new exception relating to certain accounts and notes receivable. This is set forth in paragraph (4) which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1), that is, stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. This will change present law treatment, for example, as follows: If a taxpayer acquires a note or account receivable in payment for inventory or services rendered, reports it as income, and sells it at a discount, then this amendment will provide ordinary loss treatment. Under present law such treatment is only allowed if the taxpayer is also, in effect, a dealer in such accounts or notes. Alternatively, the taxpayer may sell the account or note for something more than the discounted value that was originally reported. Under present law this difference would be capital gain unless the taxpayer is such a dealer. The amendment will cause such gain to be ordinary income.

This section is identical with section 1221 of the bill as passed by the House with two exceptions. In paragraph (4), reference to installment obligations to which section 453 (d), or to which section 1035 (relating to foreclosures of property) applies, have been eliminated by your committee as unnecessary. In paragraph (5), the reference to certain Government bonds issued at a discount prior to January 1, 1955, has been stricken so that all such Government bonds issued at a discount will continue, as under existing law, to be treated as noncapital assets.

Section 1222. Other terms relating to capital gains and losses

This section is identical with section 1222 of the bill as passed by the House. It is derived from section 117 (a) (2) through 117 (a) (11) of present law. The only substantive change is in paragraph (9) (B) (ii) which provides the computation of net capital gain in the case of taxpayers other than corporations for the purposes of the application of the net loss carryover. One step in the computation involves computing taxable income without regard to the deduction for personal exemptions. The language is added by the bill, "or any deduction in lieu thereof," which is intended to cover the deductions allowed by section 642 (b) for a trust in lieu of personal exemptions.

Section 1223. Holding period of property

This section corresponds to section 1223 of the House bill.

This section is derived from section 117 (h) which relates to the determination of the period for which a capital asset is deemed to have been held. Several substantive changes have been made.

Paragraph (1) replaces section 117 (h) (1) which provides that, in the case where property received in an exchange, has, in whole or in part, a carryover of the basis of the property exchanged, the taxpayer may add the holding period of the property exchanged to the holding period of the property received. The amendment provides that this tacking on of holding periods is only allowed where the property exchanged was also either a capital asset in the hands of the taxpayer or property described in section 1231 (relating to property used in the taxpayer's trade or business, and involuntary conversions). This amendment is only applicable if the sale or exchange of the second asset occurs after March 1, 1954. This will change prospectively the rule laid down in *Comm.* v. *Gracey* (159 F. (2d) 324), which, under present law, permitted the tacking on of the holding period of a noncapital asset to the holding period of a capital asset where the latter was received in a tax-free exchange for the former.

Paragraph (5) extends the rule of present law which provides that the holding period of stocks originally acquired as stock dividends shall include the period for which the taxpayer held the basic stock with respect to which the dividends were issued. Under the bill this rule will be applied to stock acquired in a spin-off as well as stock acquired by means of a nontaxable stock dividend.

Paragraph (8) is new. This section provides that if a taxpayer accepts delivery of a commodity in satisfaction of a commodity futures contract, the holding period of the commodity shall include the period for which the taxpayer held the futures contract. This reverses the present position of the Internal Revenue Service stated in I. T. 3919, 1948-2 C. B. 67.

Paragraph (9) incorporates a change from the drafting technique used in the present law. The subsections in this bill can relate to assets originally acquired in transactions under prior law. In present law the applicable provisions of prior laws are stated. In the bill section 1223 (9) states that the reference to any other section shall be deemed a reference to the corresponding provision of the 1939 Code or prior internal revenue laws. The sections of prior law intended here are the same ones stated in the corresponding sections of the 1939 Code. The sections corresponding to section 1081 (c) are section 371 (c) of the Revenue Act of 1938 and section 371 (c) of the 1939 Code. The sections corresponding to section 1091 are section 118 of each of the following: The Revenue Acts of 1928, 1932, 1934, 1936, and 1938 and the 1939 Code.

Four amendments were made to section 1223 of the House bill. In paragraph (1), the previously discussed reference to property used in the trade or business of the taxpayer (as described in sec. 1231), has been added. Subsection (1) (B) of the bill as passed by the House (permitting a foreclosure to be considered an exchange of indebtedness for property acquired) has been eliminated. Due to new provisions in sections 355 and 356 of subchapter C, a new subsection (1) (B) has been added to treat certain distributions covered by those sections as "exchanges" in order to permit the "tacking on" of holding periods. It has also been made clear by your committee that the tacking on of holding periods allowed in paragraph (5) will occur where the spin-off took place before January 1, 1954. Correlating changes have been made in the cross-references of paragraph (10).

PART IV—SPECIAL RU ES FOR DETERMINING CAPITAL GAINS AND LOSSES

Section 1231. Property used in the trade or business and involuntary conversions

This section corresponds to section 1231 of the bill as passed by the House but makes one amendment. It is derived from section 117 (j) of present law. Subsection (b) (2) has been amended to apply to iron ore to which section 631 (c) applies.

Section 1232. Bonds and other evidences of indebtedness

This section corresponds to section 1232 of the House bill and is derived from section 117 (f) of present law which treats redemption as a sale or exchange in the case of bonds or other evidences of indebtedness issued by a corporation (including any government or political subdivision thereof), which are in registered form or which have coupons attached.

Paragraph (1) restates the content of present law. For bonds or other evidences of indebtedness issued after December 31, 1954, the bill abandons the present restriction of capital treatment on retirement to bonds and other evidences of indebtedness which have interest coupons attached or which are in registered form. Redemption of all bonds and other evidences of indebtedness will receive capital gain or loss treatment on redemption if issued after December 31, 1954, and if they are otherwise capital assets, except to the extent that the recovery of issue discount is subject to paragraph (2).

A change is made in paragraph (1) in the treatment of certain bonds and other evidences of indebtedness issued prior to January 1, 1955, without interest coupons and not in registered form. Under the decision in *Lurie* v. *Commissioner* (156 F. 2d 436), these securities could be put in registered form at any time prior to retirement, and they would be treated as having been in registered form from the date of acquisition by the holder at retirement. This decision is overruled, prospectively, by providing that nonregistered, noncoupon bonds issued prior to March 1, 1954, must be in registered form on

March 1, 1954, in order for their retirement to be treated as a sale or exchange. A technical amendment was made to the House bill to carry out the intention to continue present law treatment, with the above exception, for bonds issued between March 1, 1954, and December 31, 1954. While this action will only have effect with respect to evidences of indebtedness issued prior to January 1, 1954, it will have application as long as these evidences are outstanding.

Section 117 (f) does not itself extend capital-gain treatment to any transaction but simply provides one of several requirements for such treatment on retirement of certain securities. Paragraph (2) of this section, however, provides specifically for capital-gain treatment and, therefore, the phrase is inserted in the first sentence of this section to the effect that this section only applies to bonds and other evidences of indebtedness which are capital assets in the hands of the taxpayer. This phrase will remove from the application of this section bonds held by a dealer in such assets and also notes receivable arising from the sale of inventory or personal services by the holder which are excluded from the capital asset category by the new provision in paragraph (4) of section 1221.

Subsection (a) (2) provides a rule for the tax treatment of amounts received on the sale, exchange, or retirement of a bond or other evidences of indebtedness. A distinction is provided between that part of such amounts which correspond to the full or partial recovery of the original issue discount on the asset and that part of the amounts received which represent capital gain. This paragraph relates only to bonds which are issued at a price which is less than the redemption price, which are held over 6 months, and which are issued after December 31, 1954. It is also provided that this subsection will not apply to bonds, the interest on which is fully exempt from taxation under section 103 relating to certain governmental obligations. A provision is added to the House bill to provide that the discount rule will not apply to any individual who purchases a discount bond at a premium (which could arise due to changes in prevailing interest rates). If such a bond should later return to selling at a discount, the rule of this paragraph would again apply.

The rule provided in paragraph (2) will operate as follows: The taxpayer, on selling a bond originally issued at a discount, will multiply the original issue discount by the fraction formed by the number of full months the bond was held by the taxpayer over the number of full months from the date of issue to the specified ultimate redemption date; any gain realized on the sale or exchange of the bond up to but not exceeding this amount will be reported as ordinary income, and the balance will be reported as capital gain; any loss on the sale or exchange of such a bond will be a capital loss. The rule may be illustrated by the following examples:

(1) An individual purchases a 10-year bond with coupon interest at 3 percent from an investment bank at a price of 90 on February 1, 1955. The redemption price is 100. It is sold February 20, 1960.

(*a*) Assume that it is sold at 94. In this case the bond has been held for 60 months of its life of 120. The fraction 60 over 120 multiplied by the discount of 10 yields 5. Any part of the gain up to 5 would be taxed as ordinary income, and, therefore, in this case the entire gain of 4 is taxable as ordinary income.

(*b*) Assume that it is resold at 97. In this case only 5 of the gain is ordinary income and balance of 2 is capital gain.

(*c*) Assume that it is resold at 80. In this case the seller realizes a capital loss of 10.

(2) If the same bond is purchased at 80 on February 1, 1960, by a second holder who keeps it to redemption at 100, he also will have held it 60 months so he will, on redemption, have 5 of ordinary income and 15 of capital gain.

Subparagraph (2) (C) provides that in the case of the sale or redemption of certain Government bonds which are covered by section 454 (a) and (c), this section shall not require the inclusion in gross income of any amount previously included in gross income. This subparagraph relates to bonds such as series E savings bonds on which the surrender value increases in an established way, the holder having an option of reporting this increase in value currently as interest income.

Paragraph (b) (1) provides a definition of the term "original issue discount." The original issue discount means the difference between the issue price and the stated redemption price at maturity. In determining this, any price at an optional call date is to be ignored. A de minimis rule is provided that if this original issue discount does not exceed one-fourth of 1 percent (as compared with the House provision of one-tenth of 1 percent), times the number of full years to maturity, then the discount will be considered to be zero for the purposes of this section. A 10-year bond sold initially at 97½ would not give rise to any calculations under this subsection, and any gain realized by holders of the bond would be capital gain if the bond was a capital asset in their hands.

Paragraph (b) (2) provides a definition of the term "issue price." In the case of bond issues registered with the Securities and Exchange Commission the term "issue price" means the initial offering price to the public at which a substantial amount of such bonds were sold. For the purposes of this section the public is not deemed to include bond houses and brokers. Ordinarily, the issue price will be the first price at which bonds are sold to the public, and the issue price will not change if, due to market developments, the brokers must sell part of the issue at a different price. The phrase "at which price a substantial amount of such bonds were sold" is intended primarily to cover any attempt to rig an artificial price in order to obtain more favorable tax treatment. Where bonds or other evidences of indebtedness are privately placed, the issue price of each one will be the price paid by the first buyer of the particular bond or other evidence, irrespective of the issue price of the remainder of the issue. For such bonds or evidences of indebtedness issued subsequent to the effective date of this act, taxpayers may avoid uncertainty by keeping with or on the bond or other evidence of indebtedness a record of the issue price and issue date.

Your committee has added language to the definition of issue price contained in the House bill, which provides that all amounts paid by the purchaser under the purchase agreement or modification thereof (for example, an extension of life of the certificate) shall be included in the issue price. This is a clarifying change. It will have particular reference to so-called face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable with an increment at a later date. A similar change was made to make it clear that in the case of, for example, face-amount certificates, the redemption price at maturity will be the price as modified through changes (such as extensions of the purchase agreement) and that it will include any dividends which are payable at maturity. It is provided in section 72 that certain relief provisions applicable to endowment contracts will be applied also to face-amount certificates.

Paragraph (b) (3) provides a definition of "date of original issue." In the case of issues of bonds and other evidences of indebtedness registered with the Securities and Exchange Commission, there shall be one date for the whole issue which shall be the first date on which they were sold to the public at the issue price. In the case of other bonds and other evidences of indebtedness each separate bond or other evidence shall have its own date of original issue, just as its own issue price. This will be the date on which it was first sold to the public.

Your committee has added a new subsection (c) to deal with the problem of bonds or other evidences of indebtedness purchased with an excess number of coupons detached, which will apply to such purchases after the date of enactment of this title, even if the bond was issued prior to such date. A bond will be considered to have an excess number of coupons detached if any of the coupons which first become payable more than 12 months after the date of purchase are not received by the purchaser. If the bond is sold on January 1, 1955, any coupons which become payable during 1955, may be detached without bringing this subsection into operation. If the bond is purchased with an excess number of coupons detached, then any gain on the later sale or exchange of such bond by such purchaser shall be treated as ordinary interest income to the extent of the difference obtained by subtracting the purchase price from the fair market value of the asset with coupons attached at the time of purchase. To illustrate: assume that a bond is selling at a price of 90 and carries a coupon rate of 3½ percent; if the bond is sold with 3 years' coupons detached, it might sell at a price of 80. At any time the purchaser sells this bond he will report the first 10 points of his gain as ordinary income. If he resells it at a price of 92 after 3 years, for example, 10 points of his gain will be deemed ordinary income, and the remainder of the gain will be deemed either ordinary income or long-term capital gain, depending upon the application of the rule provided in paragraph (2) (A).

Questions of whether a particular recovery of original issue discount is capital gain or interest in the case of bonds or other evidences of indebtedness issued before January 1, 1955, will continue to be determined under present law.

Section 1233. Gains and losses from short sales

This section is identical with section 1233 of the bill as passed by the House. It is derived from sections 117 (g) (1) and 117 (l) of the 1939 Code. Substantive changes have been made in both sections.

Subsection (a) is derived from section 117 (g) (1) which provides that gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets. This section provides that short sales of property shall give rise to gain or loss from the sale or exchange of a capital asset to the extent that the property used to close the short sale constitutes a capital asset in the hands of the taxpayer. Thus, the nature of the gain or loss from the short sale will be determined by the character of the property used to close the sale. It is specifically provided that the property used to close the short sale includes a commodity future.

Under existing law bona fide hedging transactions do not result in capital gains or losses. This result is based upon case law and regulations. To continue this result hedging transactions in commodity futures have been specifically excepted from the operation of this subsection.

These changes more closely correlate capital gains and losses on short sales to transactions involving capital assets. Thus if a dealer in securities makes a short sale of X corporation's stock and closes the short sale by delivery of the stock, an ordinary gain or loss will result if the stock so delivered was held for sale to customers in the ordinary course of trade or business. If the stock was a capital asset in his hands, a capital gain or loss would result.

Subsections (b), (d), and (e) are derived from section 117 (l) of the code.

Subsection (b) corresponds to section 117 (l) (1) except that the new provision is applicable only to transactions which under subsection (a) result in capital gain or capital loss. Where short sales do not have this result, the holding period has no importance. No other changes have been made in this subsection.

Subsection (c) is new. It excepts from subsection (b) options to sell property at a fixed price (puts) acquired on the same day on which the property identified as intended to be used in exercising the option is acquired and which, if exercised, is exercised through the sale of the property so intended. This provision applies only to puts acquired after the date of enactment of this code. Thus, a person who purchases stock on February 1, 1955, with a 3-month "put" and who fails to exercise his "put", will have a long term gain or loss if he sells the stock on September 1. If an option to sell property at a fixed price is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. The method of identification may be prescribed by the Secretary under his general power to issue regulations.

If the option is exercised by the sale of property not purchased on the same day as the option, the rule in subsection (b) will apply. If such an option is not purchased on the same day as property which could be used in the exercise of the option, the general rules applicable to options in section 1234 will apply. This subsection shall apply only with respect to such options acquired after the date of enactment of this code.

Subsection (d) corresponds to section 117 (l) (2) and no substantive changes have been made.

Subsection (e) corresponds to section 117 (l) (3) and no substantive changes have been made.

Section 1234. Options to buy or sell

This section is identical with section 1234 of the bill as passed by the House. It is partially derived from section 117 (g) (2) of existing law, insofar as it relates to the tax treatment of loss on failure to exercise an option. Insofar as it relates to gains or losses arising from the sale or exchange of options, it is new.

The Internal Revenue Service has ruled that under existing law an option, like any other property right, is subject to the general capital gain provisions of section 1221 and, hence, its sale may give rise to a capital gain or loss where the holder is not in the business of dealing in such options (G. C. M. 23677). The bill provides that in determining whether or not a capital transaction is involved, the character of the property to which the option relates should be controlling. This section changes existing law to the extent that options acquired after February 28, 1954, are regarded as capital assets only where the underlying property constitutes, or if acquired would constitute, a capital asset in the hands of the holder. Thus, options relating to noncapital assets will, if sold, give rise to ordinary gain or loss.

If the taxpayer never acquires the property subject to the option, the nature of his gain or loss is determined by whether the property would have been a capital asset if he had acquired it. For example, if a dealer in industrial property acquires an option to buy an industrial tract and fails to exercise the option, the loss would be an ordinary loss since he normally holds such property for sale to customers in the course of his trade or business. However, if he is considering buying a new home for himself and acquires an option to buy a house and sells the option at a gain, he would have a capital gain since the property, if acquired, would have been a capital asset in his hands.

Section 117 (g) (2) provides that loss to the holder and gain to the grantor on failure to exercise any option is considered a short-term capital gain or loss. This section provides that such loss to the holder will be a capital loss only where the option relates to a capital asset. Accordingly, unexercised options entered into for hedging purposes with regard to stock in trade or inventory-type assets, will be deductible as ordinary losses rather than, as today, capital losses. The gain to the grantor in all cases will be ordinary income rather than a short-term capital gain.

In order fully to equate the tax treatment of loss on failure to exercise an option to loss on the sale of such an option, such a loss, if capital in nature, is treated as a long-term loss where the option is held for 6 months. Therefore, where such an option is held for 6 months, it will make no tax difference whether the holder sells it at a loss or fails to exercise it.

The options described in section 1233 (c), i. e., puts, are specifically excepted from this section.

It is not intended that this section should permit the deduction of any loss which may be disallowed under any other provisions of this Code.

Section 1235. Sale or exchange of patents

This section is an extensive revision of section 1235 of the House bill. It has no counterpart under existing law.

Subsection (a) provides that a transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights evidenced by a patent, or consisting of an undivided interest therein, by certain holders shall be deemed the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are payable periodically over a period generally coterminous with the transferee's use of the patent or are contingent on the productivity, use, or disposition of the property transferred. The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. However, since the inventor possesses an exclusive inchoate right to obtain a patent, he may transfer his interest, whatever it may be, in any subsequently issued patent before its issuance and before as well as after he has made application for such patent. By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent). Payments which come within the scope of the section include, but are not limited to, amounts which are payable over a period generally coterminous with the transferee's use of the patent, or amounts which are measured by a fixed percentage of the selling price of the patent article, or are based on units manufactured or sold, or any other method measured by profits, production sale, or use.

Under present law, an express assignment of patent rights by the owner, or an exclusive license of the right to manufacture, use, and sell, the invention thereunder for the life of the patent, can qualify as a "sale or exchange" for tax purposes; thus, the holder can obtain capital-gains treatment on such a transfer if he falls within the "amateur" category. Many court decisions have arrived at this result, not only where the manner of payment has been a lump sum, but also where the purchase price has been conditioned on the use or profitability of the invention, i. e., where it takes the form of "royalty" payments. (See, e. g., *Kronner* v. *United States*, 110 F. Supp. 730 (Ct. Cls. 1953); *Commissioner* v. *Celanese Corp.*, 140 F. (2d) 339 (C. A. of D. C. 1944); *Commissioner* v. *Hopkinson*, 126 F. (2d) 406 (C. C. A. 2d 1942); *Edward C. Myers*, 6 T. C. 258 (1946), Non. Acq. 1950–1 CB 7.) However, in 1950 the prospect of continued litigation was engendered in this area by the issuance of Mimeograph 6490 (1950–1 CB 9), in which the Commissioner of Internal Revenue announced that he would thereafter regard such assignments or licenses as "providing for the payment of royalties taxable as ordinary income" if payment is measured by the production, sale, or use of the property transferred or if it is payable periodically over a period generally coterminous with the transferee's use of the patent. To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment.

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined. To illustrate, exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title" is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e. g., a vendor's lien) or a reservation in the nature of a condition subsequent (e. g., a forfeiture on account of nonperformance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify.

Subsection (b) specifies the categories of taxpayers who are entitled to the benefits of this section. It is limited to individuals. A "holder" is defined as any individual whose efforts created the patent property transferred, by which is meant the "first and original" inventor (or joint inventor) within the meaning of section 31 of title 35 of the United States Code. Individuals not eligible to qualify as such "first and original" inventor will not qualify under this definition: for example, the inventor's employer may not here qualify, even though he may be the equitable owner of the patent by virtue of an employment relationship with the inventor. However, your committee is desirous of extending the scope of this section to cover (in addition to inventors) those individuals who contribute financially toward the development of the invention. Accordingly, paragraph (2) of subsection (b) also includes within the definition of "holder" any other individual who acquired his interest in such property in exchange for consideration in money or money's worth (i. e., consideration capable of present valuation in monetary terms) actually paid to the creator prior to the time when the invention (to which the patent rights relate) is actually reduced to practice (as compared to "constructive" reduction to practice). This paragraph does not include any individual who is either an employer of any creator or related to any such creator within the meaning of subsection (d); however, the section does apply to all qualifying individuals, whether amateur or professional, regardless of how often they may have sold their patents. The section is not applicable to any other purchasers or assignees.

Subsection (c) provides an effective date for operation of the section: the section is to be applicable with respect to amounts received in any taxable year to which the subtitle applies, if the assignment or license agreement by virtue of which such payments arise would have qualified under this section, regardless of the taxable year in which such assignment or license took place. Such amounts will also be given consistent treatment in the hands of the payor, in that, if the transfer is considered a sale or exchange under the section, they will be regarded as part payments of a purchase price rather than royalties.

The section does not apply to sales between related taxpayers as defined in section 267 (b), with the exception of brothers and sisters. The sale of a patent between an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual would not, for example, be entitled to capital gain treatment under this section. It is not considered that this limitation will in any way narrow the opportunity of inventors to dispose of their patents through normal business channels; on the other hand, this limitation should prevent possible abuses arising from the sale of patents within essentially the same economic group.

It is the intention of your committee that, if the mode of payment is as described in subsection (a), the sale of a patent by any "holder" must qualify under the section in order for such "holder" to obtain capital gain treatment. However, the benefits of this section are to be limited to those individuals and transfers qualifying under its terms. In enacting this section, for the specific purposes set forth in this report, your committee has no intention of affecting the operation of existing law in those areas without its scope. For example, the tax consequences of the sale of patents in years to which this section is inapplicable, or by individuals who fail to qualify as "holders," or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted. Similarly, no inference is to be drawn from this section as to what constitutes a "sale or exchange" in other than the patent field. Benefits under the section are not available to nonresident aliens.

Section 1236. Dealers in securities

This section is identical with section 1236 of the bill as passed by the House. It is derived from section 117 (n) of the present law. There is no substantive change.

Section 1237. Real property subdivided for sale

Except for clarification and rearrangement of subsection (a) (2), whose effect is discussed and explained below, this section corresponds to section 1238 of the House bill. It is a new section which permits an individual who is not otherwise a real-estate dealer (as the result of his engaging in the business of selling other real property to customers) to dispose of a tract of real property, held for investment purposes, by subdividing it without necessarily being treated as a real-estate dealer with respect to all of his long-term gain.

Subsection (a) specifies that the sale of a lot or parcel from a tract of real property by an individual shall not be regarded as the sale of the taxpayer's stock in trade simply because of the sale of this subdivision or of sales activity connected with it including advertising, expenses of agents, and the like. On the other hand, sales activity with regard to other real property, such as engaging in the subdivision of other pieces of real property, shall be taken into consideration in determining whether the specific property in question has ever been or is being held for sale to customers. Furthermore, if the taxpayer has engaged in such activities in relation to other property, his activities in respect to the property in question as well as such other activity may be considered in determining whether the property in question is or has been held for sale to customers.

Subsection (a) (1) specifically makes the section inapplicable in two situations. This denial covers first the situation where the taxpayer previously held the property for sale to customers in the ordinary course of trade or business. This denial will not operate in the situation where the taxpayer was in a prior year deemed to have so held this property if in that year he would have been entitled to make use of the provisions of this section. The other situation in which the benefits of this section are inapplicable is where the taxpayer in the year in which he sells subdivided lots holds other real property for sale to customers in the ordinary course of trade or business.

Paragraph (a) (2) denies the benefits of this section to the proceeds of the sale of particular lots on the original tract of real property if the particular lots were substantially enhanced in value as a result of substantial improvement (anywhere on the tract) made by the taxpayer, deemed to be made by the taxpayer, or made by either the taxpayer or buyer pursuant to a contract of sale between the taxpayer and the buyer. If the taxpayer erects a shopping center on a part of a remote tract of unimproved real property and then subdivides and sells the remaining lots, the improvement on the shopping center part of the tract has been clearly substantial and it is most likely that the value of all the remaining lots will be substantially enhanced in value, and this section will not apply. A further example would be putting in all public utilities for the tract. However, a substantial improvement of a portion of the tract may be made which does not substantially increase the value of the remainder of the lots in the tract, although it may enhance their saleability, such as would probably be the case where the taxpayer simply erects his personal residence on one of the lots in the tract. Also, improvements which are not substantial in and of themselves, although resulting in a substantial increase in the value of the lots of the tract, such as might be the case where the taxpayer builds an inexpensive dirt "access" road across the tract, are intended to be permitted. The improvement in question here may or may not be on the particular lot sold. The question of whether or not a particular improvement is substantial, and whether it resulted in a substantial increase of the value of any particular lot sold will be a question of fact in each case. A particular improvement could increase the value of some lots and not others. Only the former lots would be disqualified from the benefits of this section. In any case, the use of the word substantial was intended to permit the taxpayer to make certain improvements without losing the benefits of this section if either the improvements were minor or they resulted in but slight enhancement of the value of the lots sold from the tract. The permissible improvements include, but are not limited to, clearing operations and the construction of minimum all-weather access roads to each lot sold. Where the climate requires it, a minimum all-weather road may include a gravel road but not a hard surface road. This paragraph also specifies that an improvement may disqualify the sale of a lot from the benefits of the section only if made by the taxpayer. Hence the taxpayer would be unaffected by the acts of others (such as trespassers), which might be deemed to improve the realty. Conversely, the paragraph provides that an improvement made by a lessee or a governmental unit may be deemed to be an improvement made by the taxpayer. The former inference is to be made where the improvement is income to the taxpayer-lessor; the latter inference arises when the improvement made by Federal, State, or local government or political subdivision thereof constitutes an addition to basis for the taxpayer, such as in the case of special assessments resulting from paving of streets. In those cases where either such inference is to be made, however, the question still remains whether the improvement was substantial, and, if so, whether it has resulted in substantial enhancement of the value of the particular lot in question which has been sold.

Paragraph (a) (3) requires that for the taxpayer to use the provisions of this section the particular lot or parcel sold must have been held for a period of 5 years. If the lot or parcel was acquired by inheritance or devise, no holding period is imposed.

Subsection (b) provides the rules for computation of tax on the sale of lots which qualify under subsection (a). If the taxpayer has not made more than five sales of lots from a single tract of real property, through the end of the taxable year, the entire proceeds will be treated as the amount realized upon the sale of a capital asset. All sales made during or after the year in which the sixth lot from a single tract is sold will come under a special 5 percent rule. Gain on such sales will be reported as ordinary income up to, but not exceeding, an amount equal to 5 percent of the selling price. The remainder will be used in determining the amount realized on the sale of a capital asset. The rule for allocating the expenditures of sale is that expenditures may be taken as deductions from gross income in determining taxable income only to the extent that the gain was reported as ordinary income. The remainder of the selling expenditures will be used in determining the amount realized on the sale of a capital asset.

Subsection (c) provides a definition of a "tract of real property." This term shall mean a single piece of real property, with two exceptions. Two or more pieces of real property shall be considered a single tract if at any time in the previous 5 years they were contiguous in the hands of the taxpayer. Two or more pieces of real property shall also be considered a single tract if they are divided only by a road, street, railroad, stream, or similar property. This rule means that if the boundary lines of the pieces of real property were continued in the same direction in which they were running at the time they met the road, street, railroad, stream, or similar property, the two pieces of real property then would meet at more than a single point. At any time following the sale or exchange of any lot or parcel, if the taxpayer makes no further sales for a period of 5 years, the remainder of the original tract will be considered a new single tract of real property. This will permit the taxpayer to start counting the sales of the first 5 lots again before the special 5-percent rule comes into operation.

Subsection (d) provides an effective date for this section which is for taxable years beginning after December 31, 1953. It is provided, however, that for the purposes of applying the definition of a tract or real property and for the purposes of determining how many sales have been made from a tract of real property, sales during the period 5 years prior to December 31, 1953, will be taken into account. Some of these sales may be of no consequence due to the 5-year rule provided in subsection (c). If sales were made in 1949, for example, these would not fall into the 5-year period if further sales were made in 1956.

Section 1238. Amortization in excess of depreciation

This section is identical with section 1239 of the bill as passed by the House. It is derived from section 117 (g) (3) of present law without substantive change.

Section 1239. Gain from sale of certain property between spouses or between an individual and a controlled corporation

This section is identical with section 1240 of the bill as passed by the House. It is derived from section 117 (o) of the Internal Revenue Code of 1939 without substantive change.

Section 1240. Taxability to employee of termination payments

This section is derived from section 117 (p) of the 1939 Code. It was not contained in the House bill, but has been added to apply capital gains treatment to proceeds of an assignment or release by an employee of his rights to receive a percentage of future profits if he had such rights prior to the date of enactment of this title under section 117 (p) of the 1939 Code.

Section 1241. Cancellation of lease or distributor's agreement

This section is new and was not contained in the House bill. It provides that payments received by a lessee for the cancellation of a lease or by a distributor for cancellation of a distributor's agreement shall be treated as received in exchange therefor. Some doubt has arisen from the decision in *Starr Bros., Inc.* v. *Commissioner* (204 F. 2d 673), as to the application of the sale or exchange concept when a lease or distribution agreement is cancelled. As to leases and distributor's agreements, this uncertainty is removed by expressly providing that cancellation constitutes an exchange. This section does not change the treatment of payments paid to a lessor as decided in *Hort* v. *Commissioner* (313 U. S. 28). Since the section only applies to distributor's agreements in which the distributor has made a substantial capital investment in the distributorship, this section will not apply to cancellation of agreements requiring no substantial capital investment (as in *Jones* v. *Corbyn,* 186 F. 2d 450) or to agreements that are not "distributor's agreements" relating to goods as distinguished from intangible property. It permits proceeds received in consideration for the cancellation of a lease or distributorship contract involving the distribution of goods to be treated as though received in exchange for the lease or agreement, insofar as the lessee or distributor is concerned. The section provides that the distributor must have a "substantial investment" in the distributorship to obtain such treatment for amounts received for cancellation of the distributorship. This is intended to require that capital or assets of consequential value be owned and utilized by the distributor in dealing in or handling the physical product or products concerning which the agreement was made. The section is only applicable to a taxpayer who owns a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the physical product or maintains a substantial inventory. As a result of these requirements no benefit from the section is obtainable by an individual who does no more than establish an office merely for his clerical operations, or who has facilities for the physical handling of only a small fraction of the goods involved in carrying on the distributorship. On the other hand, the section is not intended to differentiate between wholesale and retail distributorships. There is also no intention to prevent transactions from being considered sales or exchanges which would otherwise be so treated. Further, application of the section determines only whether an exchange of the proceeds for the lease or agreement has taken place, but not whether such proceeds are gain from the sale or exchange of a capital asset or not; the latter is to be determined by other applicable provisions of law rather than by this section. For example, proceeds from the cancellation of a lease obtained by a lessee who is in the business of entering and marketing leases would not be considered gain from the sale or exchange of a capital asset where the particular lease was held for disposition to customers in the ordinary course of business.

SUBCHAPTER Q—READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

PART I—INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Section 1301. Compensation from an employment

This section is identical with section 1301 of the House bill. It supersedes section 107 (a) of the 1939 Code, and incorporates two major improvements in the provisions of the existing law.

The first of these improvements is the introduction of the term "an employment." The existing law refers simply to "compensation for personal services." The new term "an employment" is a more specific concept and, therefore, more accurately expresses the intended meaning. This aspect of the existing law has been a source of difficulty in determining the particular unit of personal services involved. In order to meet the 36-month requirement there is a tendency to combine various sets of services which in total extend over the required period. Likewise, there is a similar tendency to separate various sets of services in order to meet the requirement that at least 80 percent of the total compensation for all of the services be received or accrued in 1 taxable year. If a taxpayer has already received a substantial payment prior to the taxable year, he may attempt to segregate the prior payment to a different service rendered by him. In order to dispose of these difficulties, this section adopts the term "an employment." The general idea underlying the new term is that the compensation for which tax relief is provided under this section must relate to a particular project on which the taxpayer worked, such as a particular law case, and not to a set of unrelated services which the taxpayer may have performed for the same person.

The definition of "an employment" is contained in subsection (b) of this section. There, the term is defined to mean an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation for such services is received. This definition will preclude a separation of services relating to a particular project, merely because the taxpayer may have received compensation for such services from different sources. Whether the period over which services are performed includes conference and study time depends upon the circumstances of the case. In general, if the compensation received specifically includes conference and study time, such time is a part of the total period over which the services were performed. The total period of an employment includes, of course, portions of the period during which the efforts of a taxpayer were unsuccessful in effecting the particular result.

The second improvement, which will effect a major change in the existing law, is contained in subsection (c) of this section, containing special rules with respect to partnerships. The general rule of this subsection is that a member of the partnership is entitled to the benefits of the section only if he has been a member of the partnership continuously for a period of 36 months. If, however, the period of the employment immediately preceding the receipt or accrual of the compensation is less than 36 months, the individual must have been a member of the partnership continuously for the period of employment. However, this section is not applicable in any case unless the employment actually covers a total period of 36 months or more from the beginning to the completion of such employment. It is immaterial in the application of this section that the taxpayer himself did not actually render any services in connection with the employment. If the taxpayer was not a member of the partnership for the entire period during which the compensation was earned by the partnership, the spreading period in the case of such individual is limited to the period during which he was continuously a member of the partnership. However, the relief provided by this section would not apply in any such case, unless the individual had been a member of the partnership continuously for a period of at least 36 months preceding the receipt or accrual of such compensation by the partnership.

Section 1302. Income from an invention or artistic work

Your committee has made two changes in this section as contained in the House bill. One is a minor drafting change and the other reduces from 36 to 24 months the period during which the individual must have been engaged in work on the invention or artistic work. This section supersedes section 107 (b) of the 1939 Code and corresponds to existing law, except for the change from 36 to 24 months described above and except that in the case of gross income from an invention, if the requirements of the section are otherwise met, the maximum period over which such income may be spread back has been increased to 60 months in lieu of the 36 months provided in existing law. In all other respects, including the definitions of the terms "invention" and "artistic work," the requirements of existing law are unchanged.

Section 1303. Income from back pay

This section is identical with section 1303 of the House bill. It supersedes section 107 (d) of the 1939 Code, and makes no substantive changes in any respect in the existing law.

Section 1304. Rules applicable to this part

This section is identical with section 1304 of the House bill. It contains the rules applicable to part I of subchapter Q of chapter 1. Subsections (a) and (b) of this section supersede and correspond to section 107 (c) and (e) of the existing law, and make no changes in these provisions.

Subsection (c) contains a new provision the purpose of which is to overrule the decision in *Hofferbert* v. *Marshall* ((C. A. 4th, 1953) 200 F. (2d) 648). This subsection provides that in computing the tax attributable to the amount of an item of gross income allocable to a particular taxable year, that amount shall be considered income only of the person who would be required to include the item of gross income in a separate return filed for the taxable year in which such item was received or accrued. For example, an attorney residing in New York in 1955 receives a fee upon completion of an employment which began in 1945. All the requirements for the application of section 1301 are met. The taxpayer and his wife file a joint return for the calendar year 1955. They filed separate returns for the years 1945, 1946, and 1947, and joint returns in 1948 and subsequent years. Under the provisions of subsection (c) of this section no part of the total fee received in 1955 but allocable to services performed in 1945, 1946, and 1947 can be considered income of the taxpayer's wife in those years.

Part II—Mitigation of Effect of Limitations and Other Provisions

Part II of subchapter Q of chapter 1, relating to the mitigation of the effect of limitations and other provisions, and containing sections 1311 through 1315, corresponds to section 3801 of the 1939 Code.

Section 1311. Correction of error

This section, which is identical with section 1311 of the House bill, corresponds, in part, to section 3801 (b) of the 1939 Code. It sets forth the general rule authorizing an adjustment of the tax for a closed year when there is a determination described in section 1312. It also sets forth certain conditions which are prerequisites to an adjustment under this part.

The phrase "or rule of law" has been inserted in section 1311 (a) to make clear that an adjustment of the tax may be authorized for a year closed by a rule of law, such as res judicata.

Section 1312. Circumstances of adjustment

This section, which is identical with section 1312 of the House bill, describes the circumstances under which an adjustment is authorized. These circumstances are similar to those described in section 3801 (b) of the former law.

Section 1312 (3) (A), which corresponds to section 3801 (b) (3) of the 1939 Code, has been expanded to apply either where the item of income was included in a return filed by the taxpayer or where the tax was paid with respect to the item. Accordingly, in addition to the cases described in section 3801 (b) (3) of the present code, this provision will apply where the taxpayer included the item in a return, whether or not tax was actually paid with respect to such item.

Several changes have been made in the provision, relating to the determination of basis, now contained in section 1312 (6). Formerly, the provision covered only those determinations of basis "for depletion, exhaustion, wear and tear, or obsolescence, or for gain or loss on a sale or exchange." The quoted language has been omitted so that the provision now applies in case of a determination of basis for any purpose. This change makes possible, for example, an adjustment under section 1311 where an inconsistent position is maintained with respect to property disposed of other than by sale or exchange, such as the redemption of a debt obligation or the abandonment of property.

Another change makes the provision relating to basis determinations applicable where a transaction was erroneously treated as affecting the basis of property. Present law limits the adjus ment to cases in which the basis of the property "depends" on the erroneously treated transaction. An example of the change would be a taxable stock dividend which the taxpayer erroneously treats as nontaxable and for which he makes a reduction in the basis of the old stock. Subsequently the taxpayer successfully asserts that he is entitled to full basis for the old stock because the prior treatment of the stock dividend was incorrect. The amendment would make section 1311 applicable inasmuch as the receipt of the stock dividend was erroneously treated as affecting the basis of the old stock. It should be noted that section 1311 would also be applicable if the taxpayer failed to include the stock dividend in gross income whether or not he in fact made an adjustment to the basis of the old stock.

The type of errors described in the basis provision have been expanded to include the erroneous allowance of a deduction for an expense properly charged to capital account or, conversely, the erroneous charging to capital account of an expense properly deductible. Thus, if the taxpayer erroneously expenses certain costs which should be capitalized and later successfully contends that such amounts should have been added to the basis of the asset, an adjustment will be authorized under section 1311. Similarly, if the taxpayer erroneously capitalizes certain costs and the Government requires that such items be eliminated from basis, relief will be provided the taxpayer under section 1311.

A further change in the provision relating to the determination of basis makes possible an adjustment in case the taxpayer with respect to whom the error occurred already owned the property at the time of the erroneously treated transaction, as well as in the case provided for under present law where such taxpayer acquired the property in the erroneously treated transaction. The effect of the amendment is significant only when the taxpayer with respect to whom the error occurred has transferred the property by gift. The operation of this change may be illustrated by the case of the stock dividend discussed above. Under present law, an adjustment would not be authorized against a taxpayer who owned the old stock at the time of the stock dividend, if such taxpayer subsequently transferred the old stock to a donee. This would result because the taxpayer who owned the old stock at the time of the stock dividend did not acquire the old stock in the erroneously treated transaction. The bill provides, however, that the adjustment may be made since the taxpayer held the old stock at the time of the erroneously treated transaction.

Section 1313. Definitions

This section, which corresponds to section 1313 of the House bill, defines the terms used in this part. These definitions correspond to those contained in section 3801 (a) of the 1939 Code.

The definition of determination now contained in section 1313 (a) has been modified to include an informal agreement executed by the taxpayer and a representative of the Treasury Department. Under the bill the Secretary will have the authority to prescribe regulations governing such agreements. It is anticipated that such informal agreements may be executed in the field, thereby eliminating the necessity of delaying an adjustment until a closing agreement can be approved, or a final decision of a court obtained, or until there is final action on a claim for refund. However, it should be noticed that if such determinations are altered or revoked, appropriate adjustments are made under section 1314 (b).

It is also anticipated that, in order to expedite the disposition of cases involving section 1311 adjustments, the Treasury Department will issue instructions to facilitate, wherever possible, the settlement, on a net basis, of deficiencies and refunds with respect to items subject to adjustment under section 1311. Thus, if a deficiency is asserted with respect to an item of income in an open taxable year and the taxpayer is entitled to a refund under section 1311 because of an adjustment respecting such item for a closed taxable year, the amount of the refund permitted under section 1311 may be applied as an offset against the deficiency, even though different taxable years are involved.

The definition of related taxpayer now appearing in section 1313 (c) has been expanded to include corporations which are members of an affiliated group, as this term is defined in the provisions relating to the filing of consolidated returns.

Section 1314. Amount and method of adjustment

This section, relating to the amount and method of making an adjustment, corresponds to section 1314 of the House bill and to provisions appearing in section 3801 (c), (d), (e), (f), and (g) of the 1939 Code. Technical amendments have been made to this section by your committee. These amendments are noted below.

Under subsection (a), as revised, the method for ascertaining the amount of an adjustment has been altered so as to make possible an adjustment even though no tax liability was incurred for the year in which the error occurred. Under present law the adjustment may be made only with respect to the tax for the year of error since no provision is made for correcting the tax of earlier or subsequent years affected by carryovers or carrybacks. The relief accorded the taxpayer may therefore be wholly inadequate if an exclusion from income or the allowance of a deduction is made in a prior year in which the taxpayer experienced a net loss. The Government also stands to lose under the present provisions if the adjustment in the prior year is by way of an inclusion in income or the disallowance of a deduction where, because of the existence of carryovers and carrybacks, the effect of the adjustment would be in taxable years other than the taxable year of the inclusion or disallowance.

Subsection (a), as amended, provides that the adjustment will be made not only for the year of the error, but also in any other taxable year affected, or treated as affected, by a net operating loss deduction or capital loss carryover determined with reference to the year of the error. The adjustment will be made only for years for which correction is otherwise prevented by some provision of law or rule of law. However, if the effect of the correction of the error applies to years which are not closed at the time of the determination, no adjustment under section 1311 is authorized. The tax for such years must be adjusted in accordance with the generally applicable procedures for assessing deficiencies or claiming refunds.

Technical amendments to subsection (a) by your committee clarify the method of computing the amount of the adjustment where a net operating loss is involved. It will be noted that the addition of the phrase "or treated as affected" in the third sentence of the subsection makes clear that the provision covers the case where, as a result of the correction of the error, the amount of the loss is reduced and, in fact, the tax to be adjusted was not affected by the net operating loss deduction.

In section 1314 (b), relating to the manner of making an adjustment, there has been inserted a new provision to take care of the problems which will arise in the event a determination described in section 1313 (a) (4) is subsequently altered or revoked. Section 1314 (b) provides that the amount of the adjustment pursuant to such determination shall be redetermined on the basis of such alteration or revocation, and any overpayment or deficiency therefrom treated as an adjustment under section 1311.

Your committee has added to section 1314 (b) a new sentence which is required as a result of the change relating to net operating loss deductions. The effect of this amendment can best be illustrated by the use of an example. Suppose that the taxpayer sustained a net operating loss for the year 1945 resulting in his being allowed in 1946 a refund of his tax for 1943. Subsequently, though, there is a determination which, under section 1311, authorized the correction of an error which occurred in 1945. If the effect of the correction of the error is to reduce the amount of the loss, an adjustment in the nature of a deficiency will be made in the tax for 1943. Under the House bill, interest would run on this deficiency from March 15, 1944. Yet, the taxpayer has had the money only from the time he received the refund in 1946. On the other hand, if the effect of the correction of the error was to increase the amount of the loss with the result that the taxpayer was entitled to an additional refund, interest should not be payable for the period prior to the end of the year in which the loss occurred. This would be consistent with the rule of section 6611 (f) relating to refunds in case of overpayments attributable to the carryback of a net operating loss. Thus, the taxpayer should not be charged interest on a deficiency for the period prior to 1946 in the example, and the taxpayer should not be entitled to interest on a refund for the period prior to 1946. The sentence added to section 1314 (b) so provides. It should be noted, however, that this rule is applicable only when the error to be corrected occurred in the year of the net operating loss and only when the tax to be adjusted was affected by a carryback.

The only change made in the provision now set forth in section 1314 (c), formerly section 3801 (e), is to indicate that an adjustment based upon a determination described in section 1313 (a) (4) may be subsequently redetermined if such determination is altered or revoked.

Section 1315. Effective date

This section, which is identical with section 1315 of the House bill, sets forth the effective date for part II. The provisions of part II, including the modifications made in the former law, are applicable in making an adjustment if the determination which results in the adjustment is made more than 90 days after the enactment of this act. For example, the new provisions relating to the making of adjustments in cases involving a net operating loss deduction may be applied in making an adjustment with respect to 1945, if the determination resulting in the adjustment became final after the prescribed time. However, if the determination became final before 90 days after the enactment of this act, the provisions of the 1939 Code remain applicable in making the adjustment.

PART III—INVOLUNTARY LIQUIDATION AND REPLACEMENT OF LIFO INVENTORIES

This part is identical with the corresponding part in the House bill and corresponds to section 22 (d) (6) of the 1939 Code. However, the period within which the taxpayer may elect to have the involuntary liquidation provisions apply has been extended for 1 year (that is, to taxable years ending after June 30, 1950, and prior to January 1, 1955).

PART IV—WAR LOSS RECOVERIES

This part is identical with the corresponding part in the House bill. This part consists of sections 1331 to 1337, inclusive. These sections correspond to the existing provisions contained in section 127 (c) (1), (2), (3), (4), (5), (d), and (e) and (f), respectively.

These sections make no change in the existing law, except rephrasing as required by the rearrangement. The provisions contained in the present section 127 (a) and (b) have been omitted, since they are applicable only to pre-1954 taxable years.

PART V—CLAIM OF RIGHT

Section 1341. Computation of tax where taxpayer restores substantial amount held under claim of right

Except for one revision this section corresponds to section 1341 of the House bill.

If the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use, and the amount of the deduction is in excess of $3,000, the tax for the subsequent year is reduced by either the tax attributable to the deduction or the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater. Under the rule of the *Lewis* case (340 U. S. 590 (1951)), the taxpayer is entitled to a deduction only in the year of repayment.

In the case of a cash-basis taxpayer, in order to be entitled to a deduction in the later year, the amount must be repaid. However, in the case of an accrual-basis taxpayer, if the item was accrued but never received, the section applies when the deduction accrues in the later year although there is, of course, no amount to be repaid. Where an accrual-basis taxpayer has received the item, the time of accrual of the deduction again determines when the section comes into operation.

The section will not apply in the case of a bad debt. Even though a debt is uncollectible, the taxpayer does not lose his unrestricted right to the money. This section is specifically made inapplicable to sales of inventory, stock in trade, except refunds made by a regulated public utility in certain cases. An accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462.

Your committee has provided that the exclusion of refunds pertaining to inventory sales will not exclude from the benefits of this section refunds made by a regulated public utility (as defined in sec. 1503 (c)) if such refunds or repayments are required to be made by the government, political subdivision, agency or instrumentality referred to in such section. Thus refunds of charges for the sale of natural gas under rates approved temporarily would be eligible for the benefits of this section.

The section will apply to cases of transferee liability such as *Arrowsmith* v. *Commissioner* (344 U. S. 6 (1952)). Thus, while the deduction in the current year is capital in nature, the taxpayer is not deprived of all relief because his tax is reduced at least to the extent of the tax attributable to the prior inclusion.

In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

Whenever the decrease in tax for the prior year is greater than the tax for the taxable year (without the deduction attributable to the item in question), the excess is treated as a payment of tax on the last day prescribed by law for payment for the taxable year and will be refunded or credited as an overpayment for that year.

Part VI—Other Limitations

This part is identical with the corresponding part in the House bill and combines sections 128 and 106 of the 1939 Code. No substantive changes are made.

SUBCHAPTER R—ELECTION OF CORPORATIONS, PROPRIETORSHIPS, AND PARTNERSHIPS AS TO TAXABLE STATUS

Part I—Alternative Taxable Status of Certain Corporations

Section 1351. Certain corporations electing to be treated as partnerships

This is a new section which permits certain corporations to elect to be treated as partnerships. There is no analogous provision in the House bill.

Subsection (a) sets forth the general rule that a domestic corporation organized after December 31, 1953, may elect, in accordance with regulations, to be treated as a partnership for tax purposes. Such an election must be made not later than 60 days after the close of the corporation's taxable year. If the election is not made at that time, then it may never be made. The election must be restricted to the corporation's first taxable year in order to avoid the possibility of an accumulation of corporate earnings and profits. Consequently, a corporation doing business prior to January 1, 1954, must liquidate and reincorporate in order to be eligible to make the election provided under this section. A corporation which has made the election provided in this section with respect to its first taxable year is required by subsection (f) to make a new election under this subsection with respect to any year in which the original shareholders own 80 percent or less of the corporate stock in order to continue to be treated as a partnership. All shareholders owning stock in the corporation at any time on or after the first day of the corporation's taxable year, up to and including the date on which the election is made, must give their consent to the election. This requirement includes shareholders who may have sold their stock prior to the date of the election.

Subsection (b) provides a list of qualifications which must be met by the corporation and its shareholders during the corporate taxable year with respect to which the election is made and the following year up to and including the date of the election.

1. At no time during this period may there be more than 10 shareholders. All such shareholders must be individuals, and if any of the shares are held by a partnership, then all the partners will be considered as individual shareholders for the purposes of this subsection.

2. All the shareholders must be actively engaged in the conduct of the business of the corporation—i. e., such shareholders must all occupy managerial positions.

3. None of the shares may be owned by a nonresident alien or a foreign partnership.

4. A corporation will not be qualified to make the election if it was a party to a tax-free corporate reorganization described in section 368 (b), formed as the result of a distribution under section 355 (or so much of section 356 as relates to section 355), or if it has acquired property from a subsidiary in a tax-free liquidation described in section 332, except in a case in which the basis of the assets received from the subsidiary is determined under section 334 (b) (2), which permits a corporation to purchase the stock of a subsidiary under a plan whereby the subsidiary will be shortly liquidated, and to take the cost of such stock as the basis of the subsidiary's assets. This restriction is also intended to eliminate the possibility of an accumulation of corporate earnings and profits.

5. The corporation may have only one class of stock outstanding. No class of stock may be preferred over another as to either dividends, distributions, or voting rights. If this requirement were not made, undistributed current earnings could not be taxed to the shareholders without great complications. In a year when preferred stock dividends were paid in an amount exceeding the corporation's current earnings, it would be possible for preferred shareholders to receive income previously taxed to common shareholders, and the same earnings would be taxed twice unless a deduction for the earnings previously taxed were allowed to the common shareholders. Such an

adjustment, however, would be extremely difficult where there had been a transfer of common stock in the interim.

6. A corporation is not qualified to make the election if more than 80 percent of its stock is owned by persons who formerly owned the corporation's business in the form of an unincorporated enterprise taxable as a domestic corporation under section 1361. This provision is necessary in order to bind proprietorships and partnerships electing to be taxed as corporations under that section to their elections.

Subsection (c) provides that a corporation making the election described in subsection (a) will be considered a partnership for purposes of subtitle A—income taxes. However, the tax imposed on self-employment income under chapter 2 shall not be made applicable to the shareholder of such a corporation. Except for purposes of the tax on self-employment income, however, each shareholder in such a corporation shall be considered a partner, having a capital and profits interest therein, in the proportion that the number of shares of stock owned by him bears to the number of shares outstanding. For example, if corporation A has 1,000 shares outstanding, and shareholder X owns 100 shares, X shall be considered a 10-percent partner in the capital and profits of A. After the election has been made, the corporation shall not be required to pay corporate taxes, but shall file an information return similar to that of a partnership which sets forth the distributive shares of its income allocable to its shareholders. The shareholders will be taxable on their distributive shares of the corporate income determined in accordance with subchapter K as though the corporation were a partnership, whether or not such income is distributed to them. All the rules of subchapter K with respect to formation, operation, distributions, liquidation, sales of interests, and any other purposes, such as taxable years, transactions between partners and partnerships, and so forth, shall be applicable to the corporation and its shareholders.

Subsection (d) provides that a shareholder who is also an employee of the corporation may not participate in a qualified employee pension and profit-sharing plan.

Subsection (e) provides that an election by a corporation to be treated as a partnership shall be irrevocable, and shall bind the electing corporation and its shareholders, as well as any corporate successor to the business of the corporation and its shareholders. Thus, if a corporation which has made the election should liquidate and reincorporate, continuing substantially the same business, the original election would still be binding.

Subsection (f), however, provides an exception to the rule that the election is irrevocable. In the first year where the electing shareholders own 80 percent or less of the corporate stock, the corporation will no longer be bound by the election, and will be taxable as a corporation for such year and for succeeding years, unless a new election is filed in accordance with subsection (a), not later than 60 days after the close of the year in which the change of ownership has been completed. Thus, if at the end of 1954, 10 percent of the shareholders are transferees who have not consented to the election, and at the end of 1955 an additional 11 percent of the shareholders are nonconsenting transferees, the corporation will be taxed as a corporation for the year 1955, unless a new election is filed, in accordance with subsection (a). A new election may not be made unless the corporation still qualifies under subsection (b). If no election is made with respect to the taxable year 1955, then it may never be made with respect to any future taxable year unless the corporation liquidates. (Of course, such a liquidation will be treated as a corporate, and not as a partnership, liquidation.)

Subsection (g) applies the constructive stock ownership rules in determining whether there has been a change of ownership. For example, corporation A has 1,000 shares outstanding of which X and Y each own 500 shares. X sells 300 shares to his son. Under this subsection, X is still considered the owner of 500 shares and, consequently, no change of ownership has taken place.

Subsection (h) provides that if a corporation electing to be treated as a partnership, or a corporate successor to the business of such a corporation, issues stock of a different class than that outstanding, the election shall be revoked for the year in which the new class of stock was issued, and subsequent years, and for all the prior years of the corporation's existence. The corporation shall be liable for all corporate taxes due from and including the year in which it was formed and such taxes may be assessed and collected as if no return had been filed. Thus, an action for the assessment and collection of such corporate taxes could be started without regard to the period of limitations.

Part II—Alternative Taxable Status of Certain Proprietorships and Partnerships

Section 1361. Unincorporated business enterprises electing to be taxed as domestic corporations

This section is intended to permit certain proprietorships and partnerships the opportunity to elect to be taxed as a domestic corporation while still conducting the business of the enterprise as a proprietorship or partnership. There is no analogous provision in the House bill.

Subsection (a) sets forth the general rule that a partnership or proprietor may elect, in accordance with regulations, to be taxed as a corporation. Such elections must be made not later than 60 days after the close of the taxable year to which the election is first applicable by the proprietor or all the partners having an interest in the enterprise at any time on or after the first day of such taxable year, up to and including the date of the election. This requirement includes any owners of the enterprise who may have sold their interests prior to the date of the election.

If in a year subsequent to the year of the election there is a change of ownership requiring another election as provided in subsection (f), then all persons owning an interest in the enterprise from the beginning of such year until and including the date of the election must elect under this subsection in order to continue to have the enterprise taxed as a corporation.

Subsection (b) provides a list of qualifications which must be met by the enterprise and its owners during the taxable year with respect to which the election is first applicable and the following year up to and including the date of the election.

Paragraph (1) provides that the enterprise may not be owned by more than 50 individual taxpayers. If a partnership own an interest in a partnership as to which an election is to be made, all of the partners of the owning partnership must be individuals and their number must be added to the other partners of the electing partnership in determining the number of partners therein.

Paragraph (2) provides that no proprietor or partner having more than a 10-percent interest in an electing enterprise, can be an owner of another proprietorship or have more than a 10-percent interest in another partnership, either of which is taxable as a domestic corporation under this section. For example, should an individual have an interest of 10 percent or less in a partnership taxed as a corporation, he may elect to have his proprietorship taxed as a corporation. However, if he should own a proprietorship taxed as a corporation, he would be unable to make the election for another proprietorship, or for a partnership in which he had more than a 10-percent interest.

Paragraph (3) provides that no proprietor or partner in an enterprise electing to be taxed as a corporation under this section may be either a nonresident alien or a foreign partnership.

Paragraph (4) provides that no proprietor or group of partners owning more than an 80 percent interest in either income or capital of the partnership formerly owned the business of the partnership as a corporation electing to be treated as a partnership under section 1351. For example, three individual shareholders owned the ABC corporation which elected to be treated as a partnership under section 1351. Should the ABC corporation be liquidated and the business of the corporation carried on as a partnership, the partners would not be able to elect to be taxed as a corporation under this section.

Paragraph (5) provides that the enterprise must be either one in which capital is a material income-producing factor, or 50 percent or more of the gross income of the enterprise consists of earnings derived from trading as a principal or from brokerage commissions derived from selling real property, stock, securities, or commodities for others. Capital is considered to be a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital. Capital would be considered a material income-producing factor if the operation of the business required a substantial inventory or a substantial investment in plant, machinery, or equipment. Under this paragraph, the enterprise, if it is not one in which capital is a material income-producing factor, must obtain more than 50 percent or more of its earnings from selling in its own name or from brokerage commissions from selling real property, stock, securities, or commodities.

Subsection (c) is intended to give the Secretary or his delegate authority to issue regulations on the method of taxing a partnership or proprietorship as a corporation. The enterprise is to be considered a corporation in all respects for purposes of income taxes, except chapter 2, relating to the tax on self-employment income and except as provided in subsection (m). Each owner of an interest in the electing enterprise is to be considered a shareholder in proportion to his interest.

Subsection (d) prevents a proprietor or partner of an enterprise taxed under this section from participating as an employee in any qualified pension and profit-sharing plans of the business.

Subsection (e) provides that the election under this section is binding on the enterprise and its owners as long as the original proprietor, or partners electing owning more than an 80-percent interest, continued to conduct the business in an unincorporated form.

Subsection (f) sets forth the rule that in any year in which the ownership of the proprietorship is changed, or the original electing partners no longer own more than 80 percent of the partnership, the election is revoked, unless the proprietor, or partners, make a new election under subsection (a), being qualified under subsection (b).

Subsection (g) is intended to make applicable the attribution of ownership rules of section 267 (c), relating to the rules for constructive ownership of stock.

Subsection (h) provides that the unincorporated business taxed under this section is subject to the normal tax and surtax imposed by section 11, the accumulated earnings tax imposed by section 531, and the alternative tax of capital gains imposed by section 1201.

Subsection (i) is intended to exclude from the income of the enterprise any income classified as personal holding company income under section 543. Income from brokerage commissions is not to be excluded from the income of the enterprise. Any income so excluded is to be taxed directly to the proprietor or the partners, and any deductions attributable to such income shall not be allowed to the enterprise but shall be allowed to the proprietor or partners. Any distributions of personal holding company income includible in the income of the proprietors or partners shall not be taxed as a corporate distribution from the enterprise since this income is taxed whether or not distributed. Any undistributed personal holding company income shall be considered as paid-in surplus, or as a contribution to the capital of the enterprise as of the close of the year in which it is earned. In this situation, the basis of the proprietor's or partner's interest in the enterprise would be accordingly increased. In determining whether rents and mineral, oil, or gas royalties are personal holding company income, all income earned by the enterprise, including personal holding company income not taxed to the enterprise, shall enter into the determination of the gross income of the enterprise for such year.

Subsection (j) provides that there shall be allowed as a deduction for salaries only those payments made to a proprietor or partners which are commensurate with the value of services actually rendered to the enterprise, and that the enterprise shall be entitled to deductions only for such items as are properly allocable to its business operations.

Subsection (k) provides that all distributions, other than distributions in partial or complete liquidation, made with respect to a proprietorship or partnership interest, except distributions of personal holding company income and compensation, shall be treated as a distribution made by a corporation to a shareholder and will be taxable as a dividend distribution to the extent of the earnings and profits of the enterprise.

Subsection (l) provides that distributions in partial or complete liquidation shall be treated as if made by a corporation to a shareholder.

Subsection (m) provides that an enterprise electing under this section shall not be considered a corporation, nor shall the proprietor or partners be considered shareholders of a corporation, for purposes of parts III and IV of subchapter C, relating to corporate organizations and reorganizations and insolvency reorganizations, except in the case where a proprietor or partner contributes property to the enterprise and gain or loss would be recognized on such contribution by applying the corporate rules. The corporate rules shall also apply to the organization of an enterprise making an election for its first taxable year.

Subsection (n) provides that there shall be no change in the basis of the assets of the enterprise or in the basis of the proprietor's or partners' interests in the enterprise because of the election under this section.

Chapter 2—Tax on Self-Employment Income

This chapter corresponds to chapter 2 of the House bill with the exception of combining subsections (b) and (c) of section 1403 into a single subsection (b), cross-references.

This chapter, relating to the tax on self-employment income, corresponds to subchapter E of chapter 1 of the 1939 Code. No substantive changes have been made, but as a result of changes made elsewhere, it has been necessary to make two changes in this chapter in order to maintain similarity of treatment of self-employment income. In section 1402 (a), which defines net earnings from self-employment, there has been inserted a provision specifically disallowing the deduction for personal exemptions. Under the former law, personal exemptions were not taken into consideration in computing the net earnings from self-employment, but this provision becomes necessary since under the new law a deduction, not a credit, is allowable for the personal exemptions. The other change merely conforms the description of income from a partnership to the term used in the new law.

Chapter 3—Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenant Bonds

This chapter, except for changes in subchapter A, is identical with chapter 3 of the House bill which made no substantive changes in present law.

SUBCHAPTER A—NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

This subchapter combines sections 143 (b) and (h) and section 144 of the 1939 Code.

In addition, your committee has amended section 1441 to require a withholding agent to also deduct and withhold tax in the case of a nonresident alien individual or partnership falling within section 1441, on amounts described in section 402 (a) (2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets. The amended section 1441 provides further that if the amount of such gain is not known to the withholding agent, he shall deduct and withhold such amount, not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld shall not be less than 30 percent of such gain. Thus, if the withholding agent does not know the amount of such gain, he is required to deduct and withhold a tax which may exceed 30 percent of such gain, but not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld is not less than 30 percent of such gain.

The effect of the amendment to section 1441, in the case of a foreign corporation to which section 1442 is applicable, is to require a withholding agent to also deduct and withhold tax of 30 percent on amounts described in section 631 (b) and (c), which are considered to be gains from the sale or exchange of capital assets. Section 1442 automatically makes applicable the qualification of section 1441 that if the amount of such gain is not known to the withholding agent, he shall deduct and withhold such amount, not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld is not less than 30 percent of such gain.

SUBCHAPTER B—TAX-FREE COVENANT BONDS

This subchapter corresponds to section 143 (a) of the 1939 Code.

SUBCHAPTER C—APPLICATION OF WITHHOLDING PROVISIONS

This subchapter combines sections 143 (c)-(g) of the 1939 Code.

CHAPTER 4—RULES APPLICABLE TO RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

This chapter is identical with chapter 4 of the House bill which made no changes from existing law in subchapter A. Subchapter B was changed as noted below.

SUBCHAPTER A—RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

This subchapter combines sections 650 and 651 of the 1939 Code.

SUBCHAPTER B—MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS

This subchapter corresponds to section 3806 of the 1939 Code.

Section 1481. Mitigation of effect of renegotiation of Government contracts

The provisions of subsections (a), (b), and (c) of this section correspond, with appropriate editorial changes and deletions, to the provisions of section 3806 of the 1939 Code.

Subsection (d) of this section provides that if the excessive profits eliminated through renegotiation relate to profits of a taxable year subject to the 1939 Code, as amended, the adjustments in respect of such renegotiation are to be made under the provisions of section 3806 of that code.

Chapter 5—Tax on Transfers To Avoid Income Tax

This chapter is identical with chapter 5 of the House bill which combined sections 1250, 1251, 1252, and 1253 of the 1939 Code with no substantive changes.

Chapter 6—Consolidated Returns

The House bill proposed to combine the rules stated in section 141 of the Internal Revenue Code of 1939 and in the consolidated returns regulations (Regulations 129) and thus place all of the rules relating to consolidated returns in statutory form. In view of the fact that desirable flexibility would be lost if this pattern were followed, and conforming amendments would be necessary with respect to each change in other parts of the code relating to income taxes in connection with every amendment made, your committee has determined to retain the present pattern in which the Secretary or his delegate pursuant to regulatory authority prescribes the rules applicable to the filing of a consolidated return. Accordingly, your committee has in substance reenacted section 141 of the Internal Revenue Code with modifications.

Section 1501. Privilege to file consolidated returns

This section is a reenactment of section 141 of the Internal Revenue Code of 1939 which described the consolidated return privilege and required that all taxpayers electing to file a consolidated return must consent to regulations prescribed by the Commissioner prior to the last day prescribed by law for the filing of such return.

Section 1502. Regulations

Section 1502 is similar to section 141 (b) of the Internal Revenue Code of 1939.

Section 1503. Computation and payment of tax

This section is a reenactment of section 141 (c) which provides for the assessment and collection of the tax on a consolidated return pursuant to regulations prescribed under section 1502. This section also provides the increase of 2 percent in the tax on a consolidated return provided by existing law. The general rule is similar to present law as is also the provision for special treatment of Western Hemisphere trade corporations with respect to the 2-percent tax. Your committee has, however, added a new provision which will eliminate the 2-percent tax in the case of regulated public utilities which are members of the affiliated group. In a manner similar to the provision applicable to Western Hemisphere trade corporations, it is provided that the tax shall not be applied to that portion of the consolidated taxable income attributable to regulated public utilities.

The term "regulated public utility" is defined as a corporation engaged in the furnishing of electric energy, gas, water, etc., whose rates are established or approved by a governmental agency. Specific provision has been made for the regulation by an agency of a foreign country. In addition, 80 percent of the income of such corporation must be from the furnishing of such service (determined without regard to dividends and capital gains and losses) for the taxable year. In addition, in proper cases revenue derived from unregulated rates where derived from a single interconnected and coordinated system will qualify.

Section 1504. Definitions

This section is a reenactment of section 141 (d), (e), (f), and (g) amended only to remove references to the excess profits tax (subch. D of ch. I of the Internal Revenue Code of 1939) and to reflect the addition of a privilege by certain corporations and partnerships to be taxed as either corporations or partnerships at their election.

The House bill prescribed that affiliation between several corporations should be based upon stock ownership of 80 percent. Your committee has restored the 95-percent stock ownership test of existing law.

The definition of includible corporations is substantially similar to present law, removing those provisions significant only for excess profits tax purposes. This is substantially in accord with the House bill. In addition, however, your committee has added (in subsecs. (b) (7) and (8)) a provision to the effect that if a corporation elects to be taxed as a partnership pursuant to section 1351 or if a partnership elects to be taxed as a corporation pursuant to section 1361, such corporation or partnership may not be an includible corporation.

Section 1504 (c) is a reenactment of section 141 (f).

Section 1504 (d) is a reenactment of section 141 (g).

Section 1505. Cross references

This section contains cross references to section 6503 (a) (1), relating to suspension of running of the statute of limitations, and to section 482, relating to allocation of income and deductions of related trades or businesses.

Subchapter B—Related Rules

Section 1551. Disallowance of surtax exemption and accumulated earnings credit

This section corresponds to section 1731 of the House bill. The provision is similar to section 15 (c) of the 1939 Code in that it provides for disallowance of the $25 exemption from surtax in certain cases. Provision is added providing for the disallowance of the $60,000 accumulated earnings credit ($30,000 in the House bill) provided in section 535 (c) in similar situations.

SUBTITLE B—ESTATE AND GIFT TAXES

CHAPTER 11—ESTATE TAX

SUBCHAPTER A—ESTATE OF CITIZENS OR RESIDENTS

PART I—TAX IMPOSED

Section 2001. Rate of tax

This section is identical with section 2001 of the House bill.

This section combines into a single schedule the rates of tax which existing law provides in two separate schedules of rates found in sections 810 and 935 of the 1939 Code. This section eliminates the necessity that exists under present law of computing both a tentative and a so-called basic tax where the taxable estate exceeds $100,000. The term "taxable" estate has the same significance as the term "net" estate under present law. Under this section, the tax (before the allowance of credits) is computed by fitting the taxable estate, determined as provided in section 2051, into the proper bracket provided for in this schedule and applying the appropriate tax and percentages indicated therein.

Section 2002. Liability for payment

Section 2002 of the House bill is adopted without change and is identical with section 822 (b) of the 1939 Code.

PART II—CREDITS AGAINST TAX

Section 2011. Credit for State death taxes

This section is identical with section 2011 of the House bill.

This section provides a separate schedule for computing credit for estate, inheritance, legacy, or succession taxes actually paid to any State, Territory, or the District of Columbia, or any possession of the United States, in respect of any property included in the gross estate. Subsections (a), (b), and (c) replace section 813 (b) of the 1939 Code. Subsection (d) defines the terms "basic estate tax," the "estate tax imposed by the Revenue Act of 1926" and the "additional estate tax" now determined under sections 810 and 935 of the 1939 Code. These terms are provided for the purpose of supplying a means of computing State death taxes and in computing the exemption provided for in section 2201 in the case of the estates of certain members of the Armed Forces.

Under present law nonresidents not citizens of the United States receive a credit for State death taxes on their entire net estate while other decedents receive a credit for State death taxes on their net estate in excess of $40,000. Under this section no credit will be granted any estate unless the taxable estate exceeds $40,000.

Section 2012. Credit for gift tax

This section is identical with section 2012 of the House bill.

This section provides for a credit for gift tax paid on any gift made by the decedent in his lifetime the amount of which is required to be included in his gross estate for estate tax purposes. It is derived from section 813 (a) (2) of the 1939 Code with no substantive change. In the case of gifts subjected to gift tax under section 319 of the Revenue Act of 1924, as amended, existing law provides for credit only against the so-called "basic" estate tax. This section provides, in the case of such gifts, for a credit not only against the "basic" estate tax but also against the tax imposed by section 2001. Equal credit is provided in the case of gifts subjected to gift tax by later provisions of law applicable to gift tax.

Section 2013. Credit for tax on prior transfers

This section corresponds to section 2013 of the House bill with substantive amendments made by your committee.

This section replaces section 812 (c) of the 1939 Code. Existing law provides for a deduction from the decedent's estate of the value of property included in his gross estate which was previously subjected to gift tax or estate tax. Under existing law, the deduction is available only in respect of property included in the decedent's gross estate which can be identified as having been received by gift from the donor within 5 years, or by bequest, devise, or inheritance from a decedent who died within 5 years, prior to the decedent's death (or as to property which can be identified as having been acquired in exchange for property so received). The deduction was designed to prevent subjecting the same property to tax twice within a relatively short period of time. However, under the existing law the benefits are measured by the rate of tax applicable to the current decedent's estate.

Subsection (a) of the House bill provides, in lieu of the deduction under present law, a credit against the tax imposed by section 2001 for all or a part of the estate tax paid with respect to the transfer of property to the present decedent by or from a person (designated as the transferor) who died within 10 years prior to the present decedent's death. Your committee has modified this section to cover the transfer of property to the decedent by a person who died within 2 years subsequent to the death of the decedent. Furthermore, subsection (a) has been clarified to make certain that the benefits of the section apply to property passing to the decedent as a result of the exercise or nonexercise of a power of appointment exercisable when the property is included in the gross estate of the donee of the power.

The term "transfer of property" is broad enough to cover the transmission of property by the transferor to the decedent under any condition or form of ownership which requires the inclusion of such property in the transferor's gross estate. This is a clarification which was not expressed in the House bill.

In order to qualify for the credit it is not essential under this section that the property transferred be identified in the estate of the decedent. However, the property must be included in the gross estate of the transferor and no credit is available merely because a gift tax may have been paid with respect to the transfer of property to the decedent.

The rules prescribed for determining the computation of the credit are found in subsections (b) and (c). Subsection (a) provides that where the transferor predeceased the decedent by more than 2 years the credit determined under subsections (b) and (c) shall be allowed in the following percentages: 80 percent if the transferor died within the third and fourth years preceding the decedent's death; 60 percent if within the fifth and sixth years; 40 percent if within the seventh and eighth years; and 20 percent if within the ninth and tenth years.

Subsection (b) provides that, subject to the limitation in subsection (c), the credit shall be an amount which bears the same ratio to the estate tax paid with respect to the estate of the transferor as the value of the property transferred to the decedent bears to the taxable estate of the transferor (for estate-tax purposes) increased by the exemption provided for under section 2052 or 2106 (a) (3), or the corresponding exemption of prior law, and decreased by any death taxes—Federal, State, foreign, or otherwise—paid with respect to the estate of the transferor. In determining the amount of the credit, the estate tax paid by the estate of the transferor shall be the estate tax paid by such estate before reduction on account of gift tax credit, or credit under this section where the transferor acquired property from a person who died within 10 years prior to the death of the present decedent. With certain limitations, the effect of this section is to subject property to estate tax only once where two or more decedents all die within a 10-year period.

Paragraph (1) of subsection (c) provides for a limitation on the credit otherwise allowable under subsection (b) . The credit cannot exceed the amount by which the estate tax imposed with respect to the estate of the present decedent (after deducting the credits for State and foreign death taxes and gift tax) exceeds such estate tax which would result if the value of the transferred property were excluded from the present decedent's estate. Your committee believes that it should be made clear that nothing in this section shall be construed as conflicting with any provisions contained in death duty treaties between the United States and foreign countries as to the order in which the credit authorized by those treaties is to be taken. If a charitable deduction is allowable to the estate of the present decedent then before making the computation referred to in section 2013 (c) (1) (B) the charitable deduction allowable is to be reduced by that part of the charitable deduction allowable which the value of the transferred property bears to the present decedent's gross estate after reduction by the amount of the deductions for expenses, indebtedness, taxes, losses, etc., allowed under sections 2053, 2054, and 2106 (a) (1). If the credit provided for in section 2013 relates to property received from two or more transferors, a separate computation shall be made with respect to the estate tax paid by the estate of each transferor in applying the ratio provided for in subsection (b). However, subsection (c) (2) provides that in such case in determining the limitation under subsection (c) (1) the property transferred from each transferor shall be aggregated. The aggregate limitation thus computed is apportioned between the property received from each transferor in the ratio that the property received from each bears to the total property received from both transferors. The credit computed by the application of subsection (b) in the case of property received from each transferor is compared separately with the limitation under subsection (c) so apportioned in applying the provisions of this section separately with respect to the property received from each transferor. The percentages provided for in subsection (a) are to be applied separately with respect to the property received from each separate transferor.

The section can be illustrated by the following example:

Assume that all decedents are United States citizens.

A dies December 1, 1953. He has a gross estate of $640,000 and no deductions. He transferred $300,000 to B.

B dies December 1, 1954. He has a gross estate of $1 million and a deduction of $50,000 for debts. B bequeathed $100,000 to D.

C dies December 1, 1952. 'He has a gross estate of $200,000, funeral expenses of $10,000 and a charitable bequest of $20,000. He transfers $100,000 to his wife, D.

D dies December 1, 1961. She has a gross estate of $800,000, a charitable deduction of $50,000, and a deduction for expenses of $50,000.

All estates paid State death taxes equal to the maximum credit for State death taxes except C, who paid a State death tax of $100. No legatee paid any estate tax imposed on the estate of the decedent.

1. Computation of credit for B:

(a) A's tax attributed to transfer of $300,000 to B (subsec. (b)):

(1) A's tax:	
A's taxable estate plus exemption	$640,000.00
Tax (from sec. 2001)	173,700.00
Less credit for State death taxes (sec. 2011)	15,600.00
Tax due	158,100.00

(2) Computation of credit:

$$\text{Credit}=\$158{,}100\times\frac{\$300{,}000}{\$640{,}000-\$173{,}700}=\$101{,}715.63$$

(b) Limitation on credit applicable with respect to B's tax (subsec. (c)):

(1) Tax payable by B without regard to this section:		
Gross estate	$1,000,000	
Less deductions	110,000	
Taxable estate	890,000	
Tax	285,000	
Less State death tax credit	30,400	
Tax before credit on prior transfers		$254,600
(2) Tax on B's gross estate excluding prior taxed transfer:		
Gross estate	$700,000	
Deductions	110,000	
Taxable estate	590,000	
Tax	177,200	
Less State death tax credit	16,000	
Tax excluding transferred property	161,200	
(3) Limitation on credit:		
No. 1	254,600	
Less No. 2	161,200	
Maximum credit allowable	93,400	
(c) Percent of credit to be taken into account:		
Since B died within 2 years of A, 100 percent of credit is to be taken into account		$93,400
Tax due		161,200

2. Computation of credit for D:

(*a*) B's tax attributable to transfer of $100,000 to D:

(1) B's tax (computed in 1 (b) (2))	$161, 200	
Credit for prior taxed transfer within 10 years	93, 400	
Tax due plus credit on prior transfers		$254, 600. 00
B's tax computed in 1 (b) (2)	161, 200	
State death taxes	30, 400	
Total death taxes		191, 600. 00

(2) Computation of credit.

$$\text{Credit}=254{,}600\times\frac{100{,}000}{890{,}000-191{,}600+60{,}000}=33{,}570.68$$

(An error in this computation in the House report has been corrected.)

(*b*) C's tax attributable to transfer of $100,000 to D:

(1) C's estate tax.

Gross estate		$200, 000. 00
Expenses		10, 000. 00
Adjusted gross estate		190, 000. 00
Less deductions:		
Marital deduction	$95, 000	
Charity	20, 000	
Exemption	60, 000	
		175, 000. 00
Taxable estate		15, 000. 00
Tax	$1, 050	
State death tax	100	

(2) Computation of credit.

$$\text{Credit}=1{,}050\times\frac{100{,}000-95{,}000}{15{,}000+60{,}000-1{,}150}=71.09$$

(*c*) Limitation on credits with respect to transfers from B and C.

(1) Tax payable by D without regard to this section.

D's gross estate		800, 000. 00
Deductions:		
Charity	$50, 000	
Expenses	50, 000	
Exemption	60, 000	
		160, 000. 00
Taxable estate		640, 000. 00
Tax	$194, 700	
Less State death tax credit	18, 000	
Tax due	176, 700	

(2) Tax on D's estate excluding prior taxed transfers.

Gross estate		695, 000. 00
Deductions:		
Charity $50{,}000-50{,}000\times\frac{105{,}000}{800{,}000-50{,}000}$	=$43, 000	
Expenses	50, 000	
Exemption	60, 000	
		153, 000. 00
Estate to be taken into account		542, 000. 00
Tax	$160, 400	
Less State death tax credit	14, 080	
Tax due	146, 320	

(3) Limitation on credit.	
No. 1	$176, 700. 00
Less No. 2	146, 320. 00
Maximum credit allowable	30, 380. 00
(4) Apportionment of limitation.	
Transfer from C	5, 000. 00
Transfer from B	100, 000. 00
Total	105, 000. 00
Portion to transfer from C ($^{5}/_{105}$ of $30,380)	1, 446. 67
Portion to transfer from B ($^{100}/_{105}$ of $30,380)	28, 933. 33

(*d*) Application of percentage limitation to estate of D.

Unadjusted credit for—		
(1) Transfer from C	$71. 09	
Percent taken into account	20	
Credit for transfer from C		$14. 22
(2) Limitation for transfer from B	$28, 933. 33	
Percent taken into account	40	
Credit for transfer from B		11, 573. 33
Total credit		11, 587. 55

Your committee has revised subsection (d) so as to provide that the value of property transferred to the decedent shall be determined in the same manner as the value of property interests passing to a surviving spouse under section 2056 is determined. Your committee believes that this amendment will provide for greater certainty.

The value of any property transferred to the decedent shall be determined in the same manner as if the value of a gift to the decedent of such property at the death of the transferor were being made, taking into account all encumbrances or obligations. If the transferor by his will leaves to the decedent real estate subject to a mortgage (whether or not such mortgage was a personal liability of the transferor), the value of the property transferred to the decedent does not under this section include the mortgage. If, however, the transferor by his will directs the executor to pay off the mortgage, such payment constitutes an additional amount transferred to the decedent. If the transferor bequeaths certain property to the decedent subject, however, to his agreement, or a charge on the property, for payment of $1,000 to X, the value of the bequest is the value of the property reduced by $1,000.

The property transferred to the decedent by the transferor is only such property as the transferor can give. If the transferor by his will leaves the residue of his estate to the decedent and he pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the decedent cannot be included in the value of the property transferred to the decedent.

Your committee has also clarified subsection (d) to make it clear that the term "property" denotes any beneficial interest in property transferred to the decedent, including a general power of appiontment as defined in section 2041.

Section 2014. Credit for foreign death taxes

This section is identical with section 2014 of the House bill.

This section combines into a single section the provisions provided by existing law in sections 813 (c) and 936 (c) of the 1939 Code. No substantive changes have been made.

Section 2015. Credit for death taxes on remainders

This section except for a clarifying change corresponds to section 2015 of the House bill. The provisions of this section, as stated in the House bill, have been clarified so as to indicate that the section only applies where an election is made under section 6163 (a) to postpone payment of the estate tax attributable to a reversionary or remainder interest.

Section 2016. Recovery of taxes claimed as a credit

This section corresponds to section 2016 of the House bill. However, your committee has revised this section to provide that, consistent with the provisions of section 905 (c) in the case of the recovery of tax previously allowed as a credit, no interest shall be assessed or collected on any amount of tax due as the result of the recovery by the executor of death taxes paid to a foreign country where credit therefor has been previously allowed, for any period before the receipt of such refund. This provision, however, specifies that interest may be assessed and collected to the extent interest was paid by the foreign country on such refund.

Part III—Gross Estate

Section 2031. Definition of gross estate

This section is identical with section 2031 of the House bill.

Subsection (a), except for a minor clerical change, corresponds to the introductory material in section 811 of the 1939 Code. Subsection (b) corresponds to section 811 (k).

Section 2032. Alternate valuation

This section corresponds to section 2032 of the House bill and is a restatement of section 811 (j) of the 1939 Code. Existing law permits the executor, if he so elects upon his return, to value the property included in the gross estate as of a date 1 year after the decedent's death or, in the case of such property distributed, sold, exchanged, or otherwise disposed of at an earlier date, the value at such date of disposition. Subsection (a), as stated in the House bill, would have limited the exercise of such an election to cases where the aggregate value of all items in the gross estate declined to 66⅔ percent of the value of the aggregate of all such items as of the date of the decedent's death. Your committee has revised this section so as to remove this limitation. The election is to be exercised in the same manner and at the same time as provided for under present law. Except for the restatement noted above and for minor clerical changes, this section corresponds to section 811 (j) of the 1939 Code.

Section 2033. Property in which the decedent had an interest

This section is identical with section 2033 of the House bill.

This section, except for minor clerical changes, corresponds to section 811 (a) of the 1939 Code. No substantive change has been made.

Section 2034. Dower or curtesy interests

This section is identical with section 2034 of the House bill.

This section, except for minor clerical changes, corresponds to section 811 (b) of the 1939 Code. No substantive change has been made.

Section 2035. Transactions in contemplation of death

This section is identical with section 2035 of the House bill.

This section combines into a single section, the provisions in existing law under sections 811 (c) (1) (A) and 811 (l) of the 1939 Code, and makes no substantive change in existing law.

Section 2036. Transfers with retained life estate

This section is identical with section 2036 of the House bill.

This section, except for clerical changes, corresponds to section 811 (c) (1) (B) of the 1939 Code, as amended. No substantive change has been made.

Section 2037. Transfers taking effect at death

This section is identical with section 2037 of the House bill.

This section is a combination and revision of existing law found in sections 811 (c) (1) (C), 811 (c) (2), and 811 (c) (3) of the 1939 Code. This section corresponds to provisions of existing law insofar as they relate to transfers of property made prior to October 8, 1949. This section applies substantially the same rules now prescribed in section 811 (c) (2) of the 1939 Code in the case of transfers made prior to October 8, 1949, to transfers made on or after that date with the exception that, if the decedent has retained a reversionary interest in the property immediately before the decedent's death exceeding 5 percent of the value of such property, it is immaterial whether the reversionary interest arose by the express terms of the instrument of transfer or by operation of law.

The decedent's reversionary interest is to be valued by recognized valuation principles and without regard to the fact of the decedent's death. Where it is apparent from the facts that property could have reverted to the decedent under contingencies that were not remote, the reversionary interest is not to be necessarily regarded as having no value merely because the value thereof cannot be measured precisely.

Section 2038. Revocable transfers

This section is identical with section 2038 of the House bill.

This section, with one exception, corresponds to section 811 (d) of the 1939 Code. Section 811 (d) (4) has been omitted in view of its extremely limited application.

Section 2039. Annuities

This section generally corresponds to section 2039 of the House bill.

This section is new and does not correspond to any specific provisions of existing law. With certain limitations, this section requires the inclusion in the decedent's gross estate of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement (other than as insurance under policies on the life of the decedent) entered into after March 3, 1931, if under the contract or agreement an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. Your committee has revised this section so as to make it clear that the provisions of this section apply not only to cases where an annuity was payable to a decedent but also to contracts or agreements under which a lump-sum payment was payable to the decedent or the decedent possessed the right to receive such a lump-sum payment in lieu of an annuity. For purposes of this section, the term "annuity" includes periodic payments for a specified period of time. The following are examples of contracts, but are not necessarily the only forms of contracts, to which this section applies:

(1) A contract under which the decedent immediately before his death was receiving or was entitled to receive for the duration of his life an annuity, or other stipulated payment, with payments thereunder to continue after his death to a designated beneficiary if surviving the decedent.

(2) A contract under which the decedent immediately before his death was receiving or was entitled to receive, together with another person, an annuity, or other stipulated payment payable to the decedent and such other person for their joint lives, with payments thereunder to continue to the survivor following the death of either.

(3) A contract or agreement entered into by the decedent and his employer under which the decedent immediately before his death and following retirement was receiving or was entitled to receive an annuity or other stipulated payment, payable to the decedent for the duration of his life and thereafter to a designated beneficiary, if surviving the decedent, whether the payments after the decedent's death are fixed by the contract or subject to an option or election exercised or exercisable by the decedent.

(4) A contract or agreement entered into by the decedent and his employer under which at decedent's death, prior to retirement or prior to the expiration of a stated period of time, an annuity or other payment was payable to a designated beneficiary if surviving the decedent.

(5) A contract or agreement under which the decedent immediately before his death was receiving or was entitled to receive an annuity for a stated period of time, with the annuity or other payment to continue to a designated beneficiary, upon the decedent's death prior to the expiration of such period, if surviving the decedent.

The amount to be included in the gross estate is the value at the decedent's death of the annuity or other payment receivable by the survivor of the decedent, and it is immaterial whether the payments to the survivor are payable in a lump sum, in installments, in the same, or in a greater or lesser amount than the annuity or payment to the decedent.

This section applies only to that part of the value of the annuity or other payment receivable by the surviving beneficiary which the decedent's contribution to the purchase price of the contract or agreement bears to the total purchase price thereof. For example, assume that the value of the annuity to the beneficiary at decedent's death is $20,000 and that the decedent contributed one-half of the purchase price of the contract. In such case, $10,000 would be includible in the decedent's gross estate.

In determining the amount of the decedent's contribution to the purchase price of the contract there shall be taken into account contributions made by his employer, if made by reason of decedent's employment, except contributions made by the employer to a trust or plan meeting the requirements of section 501 (e), as stated in the House bill, that is, certain qualified pension, stock bonus, profit-sharing or retirement plans. In view of certain changes made by your committee the requirements referred to are now contained in section 401 and, accordingly, it has been necessary in this section to make corresponding changes herein. However, the decedent's contributions under any such trust or plan shall be taken into account. The contributions of an employer (whether or not to an employee trust or fund forming part of a pension, annuity, retirement, bonus or profit-sharing plan) shall be considered to have been made by reason of decedent's employment if, for example, the annuity or other payment is offered by the employer as an inducement to employment, or a continuance thereof, or if the contributions are made by the employer in lieu of additional compensation or other rights, if so understood by employer and employee whether or not expressly stated in the contract of employment or otherwise.

Subsection (c) of this section as provided for in the House bill would exempt from the application of this section, certain annuities or other payments under certain employee trusts which meet the requirements of section 501 (e) and under certain retirement annuity contracts purchased by an employer which meet the requirements of that section. Your committee has revised this subsection so that the exemption also applies to annuities or other payments under a contract purchased by an employee trust and also under plans which meet the requirements of section 401 (a) at the time of the termination of the plans if occurring earlier than the decedent's separation from employment. Your committee has also modified subsection (c) as it appears in the House bill to make it clear that where the decedent contributes to a plan provided for in section 401 (a), the amount to be included in the decedent's gross estate shall be only that proportion of the annuity or other payment receivable by any beneficiary which the total payments or contributions made by the decedent bears to the total payments or contributions made.

Your committee has also amended subsection (c), as stated in the House bill, so as to apply those provisions to decedents dying after December 31, 1953.

Where the annuity is payable out of a fund or under a plan where the employer's contributions to a particular employee's account cannot be readily ascertained, the total contributions may, in the absence of a more precise method of determination, be considered to be the value of the annuity payable to the decedent and his survivor as of the time such annuity becomes fixed. Such value is to be computed in accordance with the provisions of the regulations which prescribe methods for valuing annuities. For example, assume that the decedent had retired under an approved pension plan 10 years prior to his death. At the time of his retirement he elected to receive an annuity payable to him during his life and a lesser amount payable to his widow during the time she survived him. The annuity was payable out of a fund to which he had contributed $10,000 during his employment. His employer also contributed to the fund but such contributions were not credited to individual employees. The total value of the annuities payable to the decedent and his survivor at the time of the decedent's retirement was $40,000 and the value of the annuity payable to the widow was $16,000 as of the date of the decedent's death. The amount includible in the gross estate under this section is $4,000. $(\$16,000\times\frac{10,000}{40,000})$.

The provisions of this section shall not prevent the application of any other provision of law relating to the estate tax. For example, if a contract provides for a refund of a portion of the cost thereof, in the event of the decedent's premature death, payable to the decedent's estate the amount thereof shall be treated as any other property of the decedent. This section does not, however, apply to insurance under policies on the life of the decedent to which section 2042 is applicable.

The provisions of this section are applicable only to annuities or *other* payments payable to the decedent, or which the decedent possessed the right to receive, either alone on in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. The rules applicable under section 2036 in determining whether the annuity or *other* payment was payable to the decedent, or whether he possessed the right thereto, for his life or such periods shall be applicable under this section.

Section 2040. Joint interests

This section is identical with section 2040 of the House bill.

This section, except for clerical changes, corresponds to section 811 (e) of the 1939 Code. No substantive change has been made.

Section 2041. Powers of appointment

This section is identical with section 2041 of the House bill and corresponds to section 811 (f) of the 1939 Code.

Section 2042. Proceeds of life insurance

This section is identical with section 2042 of the House bill.

This section is a revision of section 811 (g) of the 1939 Code. Under existing law, proceeds of insurance under a policy upon the life of the decedent receivable by beneficiaries other than the executor are includible in the decedent's gross estate in the proportion that the amount of premiums or other consideration paid directly or indirectly by the decedent bears to the total amount of the premiums paid for the insurance. Under existing law, premiums paid by the decedent on or before January 10, 1941, are excluded in applying the proportion mentioned if the decedent at no time after that date possessed any of the incidents of ownership in the policy. This section revises existing law so that payment of premiums is no longer a factor in determining the taxability under this section of insurance proceeds. Insurance proceeds payable to the executor will continue to be taxed as under existing law. This section also requires the inclusion in the decedent's estate of insurance proceeds receivable by all other beneficiaries under a policy on the decedent's life with respect to which the decedent at death possessed any of the incidents of ownership exercisable either alone or in conjunction with any other person. This provision corresponds to existing law with one exception. Under existing law, in determining whether a decedent possessed incidents of ownership in the policy at death, a reversionary interest is not treated as an incident of ownership. However, this section revises existing law in that respect to provide that the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. In determining whether such interest exceeded 5 percent, this section provides rules essentially the same as prescribed in section 2037 for determining whether, in the case of certain transfers, the decedent retained a reversionary interest in the transferred property.

Section 2043. Transfers for insufficient consideration

This section is identical with section 2043 of the House bill.

Subsection (a) of this section, except for clerical changes, corresponds to section 811 (i) of the 1939 Code.

Subsection (b) of this section, except for a clerical change, corresponds to the last paragraph of section 812 (b) of the 1939 Code. No substantive change has been made.

Section 2044. Prior interests

This section is identical with section 2044 of the House bill.

This section, except for clerical changes, corresponds to section 811 (h) of the 1939 Code. No substantive change has been made.

Part IV—Taxable Estate

Section 2051. Definition of taxable estate

This section is identical with section 2051 of the House bill.

This section corresponds with the introductory material in section 812 of the 1939 Code. The term "taxable estate" has the same meaning as "net estate" under existing law.

Section 2052. Exemption

This section is identical with section 2052 of the House bill.

This section, except for technical changes, corresponds with section 935 (c) of the 1939 Code. Existing law provides for an exemption of $100,000 in determining the taxable estate for purposes of computing the "basic" estate tax. The $100,000 exemption has been omitted by reason of the elimination of the "basic" estate tax.

Section 2053. Expenses, indebtedness and taxes

This section is identical with section 2053 of the House bill.

This section is a revision of section 812 (b) of the 1939 Code. Subsection (a) of this section provides for a deduction from the gross estate of the amounts of the following items:

(1) Funeral expenses,

(2) Administration expenses,

(3) Claims against the estate, and

(4) Unpaid mortgages upon, or any indebtedness in respect to property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the decedent's gross estate.

These items are allowable as deductions under existing law under section 812 (b) of the 1939 Code and all of the rules applicable to such items under the existing provision of law are adopted in this section with the following exception. Existing law provides that the total allowance in respect of such items cannot exceed the value of property included in the decedent's gross estate subject to claims. This section removes that limitation in the case of such items where the amounts thereof are paid (whether or not the total of all such items is in excess of property subject to claims) prior to the time prescribed for the filing of the estate tax return. For example, if the decedent's estate includes only property held by the decedent and his surviving spouse as tenants by the entirety, such items as funeral expenses, debts and other valid claims if allowable under local law and paid by the spouse prior to the time for filing the estate tax return, will be allowed by this section.

In addition, subsection (b) allows as a deduction from the gross estate amounts representing expenses incurred in administering property not subject to claims included in the gross estate. All of the rules applicable to the expenses enumerated in subsection (a) of this section are equally applicable to the expenses described in subsection (b) except that a deduction for expenses incurred in administering property not subject to claims will be allowed if paid prior to the expiration of the period of limitations for assessment provided in section 6501. Such expenses include such items as principal commissions paid in respect of trust property included in the gross estate, and attorneys' fees incurred to contest the inclusion of the trust property in the decedent's gross estate.

Section 2054. Losses

This section is identical with section 2054 of the House bill.

This section, with the exception of certain conforming clerical changes, corresponds with the provisions found in the last sentence of the first paragraph of section 812 (b) of the 1939 Code.

Section 2055. Transfers for public, charitable, and religious uses

This section corresponds to section 2055 of the House bill, with one exception. Your committee has amended this section so as to allow an additional deduction for transfers to or for the use of any veterans' organization incorporated by act of Congress, or of its departments or local chapters or posts, no part of the net earnings of which inures to the benefit of any private shareholder or individual. Except for this change, this section corresponds substantially to section 812 (d) of the 1939 Code.

Section 2056. Bequest, etc., to surviving spouse

This section corresponds to section 2056 of the House bill, with the exception of the amendments discussed below.

This section, with the exception of the revisions indicated herein, corresponds to section 812 (e) of the 1939 Code. All of the rules prescribed in existing law with respect to terminable interests are adopted by this section except that this section specifically provides exceptions from the terminable interest rule in the case of the following:

(1) An interest in property passing from the decedent to his surviving spouse (whether or not in trust) if such spouse is

entitled for life to all of the income from a specific portion of the interest, payable annually or at more frequent intervals, with power in the surviving spouse to appoint such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in such case the power is exercisable in favor of others), and with no power in any other person to appoint any part of such specific portion, to any person other than the surviving spouse. Except under the conditions described in subsection (b) (3), as modified by your committee, this provision is applicable only if such power in the surviving spouse to appoint such specific portion, whether exercisable by will or during life, is exercisable by such spouse alone and in all events (sec. 2056 (b) (5)); and

(2) An interest passing from the decedent consisting of the proceeds under a life insurance, endowment, or annuity contract, if under the terms of the contract such proceeds are payable in installments or are held by the insurer subject to an agreement to pay interest thereon (whether the proceeds, upon the termination of any interest payments, are payable in a lump sum or in annual or more frequent installments), and such installment or interest payments are payable annually or at more frequent intervals, commencing not later than 13 months after the decedent's death, and a specific portion of all such amounts, payable during the life of the surviving spouse are payable only to such spouse, and such spouse has the power to appoint such specific portion, payable under such contract (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), with no power in any other person to appoint such specific portion to any person other than the surviving spouse. Except under the conditions described in subsection (b) (3), as modified by your committee, this provision is applicable only if, under the terms of the contract, such power in the surviving spouse to appoint such specific portion, whether exercisable by will or during life, is exercisable by such spouse alone and in all events (sec. 2056 (b) (6)).

For example, if the decedent in his will provided for the creation of a trust under the terms of which the income from all or one-half of the trust property is payable to this surviving spouse with uncontrolled power in the spouse to appoint all or such one-half of the trust property by will, such interest will qualify as an exception from the terminable interest rule. The terminable interest rule will also not apply, for example, in the case of equivalent interests in the proceeds of insurance passing to the surviving spouse. Subsection (b) (7), of the House bill, specifically excepted from the terminable interest rule certain payments for the support of the surviving spouse. Your committee has deleted this provision.

The exceptions to the terminable interest rule provided for in sections 2056 (b) (5) and (6) do not, however, authorize the allowance of a deduction otherwise prevented by other provisions of section 2056.

Existing law provides that, if during the calendar year 1942 or after April 2, 1948, certain property held as community property is converted by the decedent and his surviving spouse into separate property, such separate property shall, for the purpose of computing the maximum amount allowable as a marital deduction, be considered as "held as such community property." This section adopts a similar rule in the case of conversions of such community property taking place any time after December 31, 1941.

Subsection (b) (3) as contained in the House bill provides an exception from the general rules in subsection (b) (1) relating to terminable interests where the surviving spouse's death within 6 months after the decedent's death, or her death with the decedent in a common disaster, will cause a termination of the interest passing to the surviving spouse if, in fact, termination does not so occur. Under the House bill this exception to the terminable interest rule applies only to the provisions found in paragraph (1) of subsection (b). Your committee has revised paragraph (3) to provide that the provisions of that paragraph apply equally to all of the terminable interest rules in the entire subsection (b).

SUBCHAPTER B—ESTATES OF NONRESIDENTS NOT CITIZENS

Section 2101. Tax imposed

This section is identical with section 2101 of the House bill.

This section, except for clerical changes, corresponds to section 860 of the 1939 Code.

Section 2102. Credits against tax

This section is identical with section 2102 of the House bill.

This section is a restatement in direct form of similar provisions stated indirectly in existing law in sections 813 (a) (2) and 813 (b) of the 1939 Code. This section extends to estates of nonresidents not citizens of the United States the benefits of the credits provided for in sections 2011, 2012, and 2013 (credits for State death taxes, gift tax, and tax on prior transfers). With one exception, this provision makes no change in existing law. Existing law provides a credit for State death taxes, in the case of estates of nonresidents not citizens of the United States, with respect to all property (regardless of amount) included in the gross estate and subjected to State death taxes. No credit for such taxes is provided by this chapter in the case of the estates of such decedents where the value of the taxable estate does not exceed $40,000.

Section 2103. Definition of gross estate

This section is identical with section 2103 of the House bill.

This section, for which there is no corresponding single provision of existing law, defines the term "gross estate" in the case of the estates of nonresidents not citizens of the United States. This section is merely a statement in a more direct form of existing law.

Section 2104. Property within the United States

This section is identical with section 2104 of the House bill.

This section is a restatement of section 862 of the 1939 Code. Under existing law, in the case of estates of nonresidents not citizens of the United States, shares of stock of a foreign corporation are considered to be property within the United States if the certificates therefor are physically located in the United States at the decedent's death. This section provides that shares of stock owned and held by estates of nonresidents not citizens of the United States are deemed to be property within the United States only where the shares of stock are issued by a domestic corporation. Thus, shares of stock of a Canadian corporation are not deemed to be property within the United States even though the certificates therefor may be physically located in the United States at the decedent's death. This section makes no other change in respect of existing law.

Section 2105. Property without the United States

This section is identical with section 2105 of the House bill.

This section, except for the deletion of obsolete matter, corresponds to section 863 of the 1939 Code.

Section 2106. Taxable estate

This section is identical with section 2106 of the House bill.

This section, with one substantial change, corresponds generally to section 861 of the 1939 Code. Existing law provides, in the case of estates of nonresidents not citizens of the United States, for a deduction for certain property previously taxed. This deduction has been replaced in section 2013 with a credit for estate tax paid by the estate of certain decedents in respect of certain property transferred to the decedent. The benefits of section 2013 are extended to estates of nonresidents not citizens of the United States by the provisions of section 2102. Minor clerical changes have also been made in existing law and obsolete provisions of existing law have been omitted.

SUBCHAPTER C—MISCELLANEOUS

Section 2201. Members of the Armed Forces dying during an induction period

This section is identical with section 2201 of the House bill and corresponds to section 939 of the 1939 Code.

Section 2202. Missionaries in foreign service

This section is identical with section 2202 of the House bill and corresponds to section 850 of the 1939 Code.

Section 2203. Definition of executor

This section is identical with section 2203 of the House bill and corresponds to section 930 (a) of the 1939 Code.

Section 2204. Discharge of executor from personal liability

This section is identical with section 2204 of the House bill.

This section corresponds to section 825 (a) of the 1939 Code.

Section 2205. Reimbursement out of estate

This section is identical with section 2205 of the House bill.

This section corresponds to section 826 (b) of the 1939 Code.

Section 2206. Liability of life insurance beneficiaries

This section is identical with section 2206 of the House bill.

This section corresponds to section 826 (c) of the 1939 Code.

Section 2207. Liability of recipient of property over which decedent had power of appointment

This section is identical with section 2207 of the House bill.

This section corresponds to section 826 (d) of the 1939 Code.

CHAPTER 12—GIFT TAX

SUBCHAPTER A—DETERMINATION OF TAX LIABILITY

Section 2501. Imposition of tax

This section is similar to section 2501 of the House bill.

This section imposes the gift tax for the calendar year 1955 and subsequent calendar years, replacing section 1000 (a) of the 1939 Code. Under existing law the tax is imposed on the transfer of property by gift by any individual, resident or nonresident; but, in the case of a nonresident not a citizen of the United States, its application is limited to property situated within the United States by section 1000 (b). This section differs from existing law in that it will exempt from the tax a transfer of intangible property (such as stocks and bonds) made by a nonresident who is not a citizen of the United States and who was not engaged in business in the United States during the calendar year in which the transfer was made.

Your committee has made a clarifying amendment of the provisions in the House bill to more clearly indicate that the gift tax does not apply to transfers by nonresidents not citizens of the United States of property situated outside the United States at the time of the gift.

Section 2502. Rate of tax

This section corresponds to section 2502 of the House bill.

This section is derived from sections 1001 (a), 1030 (a), 1001 (b), and 1008 (a) of the 1939 Code. No change in substance has been made.

Section 2503. Taxable gifts

Subsection (a) of this section is identical with subsection (a) of section 2503 of the House bill.

Subsection (b) of this section corresponds to section 1003 (b) (3) of the 1939 Code in the House bill, but your committee has made a substantive amendment. Certain court decisions have indicated that, although a gift may be made in trust of the present right to receive income, if powers are given to the trustee in his uncontrolled discretion to pay over the trust principal to the income beneficiary, the income interest is not susceptible of determination and, therefore, is to be treated as a gift of a future interest. Your committee believes that such determinations, in certain instances, may reach undesirable results. Accordingly, subsection (b) has been modified by your committee to provide that, where there has been a transfer to any person of a present interest in property the possibility that such present interest may be diminished by the exercise of a power shall be disregarded in determining whether the gift of such an interest is a future interest, provided that no part of such interest will at any time pass to any other person.

Thus, assume that under the terms of a trust the income is payable to A for life, with the remainder payable to B upon A's death, and that the trustee has uncontrolled power to pay over the trust principal to A in whole or in part at any time. Although in such case A's present right to receive income may be terminated, no other person has the right to such income interest. Accordingly, under this subsection as modified, the present right in A will not be treated as a gift of a future interest. This rule will not apply, however, if the trustee could pay over any part of the corpus during A's life to persons other than A.

Subsection (c), a new provision adopted in the House bill, describes a certain type of gift to a minor which will not be treated as a gift of a future interest. Your committee has amended the provisions of the House bill to provide that it is not necessary that the property or income therefrom be actually expended by or for the benefit of a minor during minority so long as all such amounts not so expended will pass to the donee upon attaining majority and, in the event of his prior death, will be payable to his estate or as he may appoint under a general power of appointment. This subsection has also been modified to indicate that the general power of appointment need not be limited to one exercisable by will.

Section 2504. Taxable gifts for prior years

This section is identical with section 2504 of the House bill.

This section has no counterpart in existing law. However, subsections (a) and (b) of this section do not make any substantive change in existing law but are necessary for the purpose of requiring that the amount of taxable gifts in preceding years for the purpose of computing the tax in a current year be computed on the basis of the law in effect at the time the earlier gifts were made.

Under present law, the amount of gifts made in a prior year may be adjusted for the purpose of computing the tax for a current year, even though the statutory period within which an additional tax might be assessed for the prior year has expired. Subsection (c) of this section will prevent the value of a gift from being adjusted under such circumstances in cases where a tax was paid for the prior year in question. This subsection, however, will not prevent such an adjustment if no tax was paid for the prior year and, in any case, will not prevent adjustment where issues other than valuation of property are involved.

Subsection (d) of this section is necessary due to the substitution of the word "taxable" in this bill for the word "net" in existing law.

SUBCHAPTER B—TRANSFERS

Section 2511. Transfers in general

This section is identical with section 2511 of the House bill.

Subsection (a) of this section, except for clerical changes, corresponds with section 1000 (b) of the 1939 Code.

Under present law, in the case of a nonresident not a citizen of the United States, stock of a corporation is treated as having a situs in the United States either if the corporation is incorporated in the United States, or if the stock certificate is physically located here. Under subsection (b) of this section, such stock will have a situs in the United States only if the corporation is incorporated here.

Section 2512. Valuation of gifts

This section is identical with section 2512 of the House bill.

This section is derived from sections 1002 and 1005 of the 1939 Code and does not contain any substantive changes.

Section 2513. Gift by husband or wife to third party

This section except for a minor technical change in the title of the section, is identical with section 2513 of the House bill and corresponds to section 1000 (f) of the 1939 Code.

Section 2514. Powers of appointment

This section is identical with section 2514 of the House bill.

This section is derived from section 1000 (c) of the 1939 Code and contains no change in substance. However, the provisions of section 452 (b) (2) of the Revenue Act of 1942 and section (2) of Public Law 635 (80th Cong.), both of which are permanent provisions of law although not enacted as amendments to the code, have been included.

Section 2515. Tenancies by the entirety

This section corresponds to section 2515 of the House bill.

Under present law a husband who purchases property and takes title in the name of himself and his wife as tenants by the entirety is held to have made a gift of the value of the property less the present worth of his retained rights therein, which are the right to receive either one-half or all (depending upon State law) of the income therefrom during the joint lives of the spouses, and the right to receive the property on the death of his wife, provided he survives her. On the termination of the tenancy (other than by death) the younger of the spouses will be held to have made a gift to the older.

The House bill provides that, in the case of the creation of a tenancy by the entirety in real property, the donor may elect to have the transaction treated as it is under present law, but that, unless he does so, it will be treated as not resulting in a gift. Where the creation of a tenancy by the entirety is not treated as a gift, the termination of the tenancy (other than by the death of a spouse) is deemed to have resulted in a gift by a spouse to the extent that the proportion of the total consideration furnished by such spouse multiplied by the proceeds of such termination exceeds the value of such proceeds of termination received by such spouse. The election referred to above is required by subsection (c) to be made on a gift tax return, filed by the donor within the time prescribed by law, for the calendar year in which the tenancy was created. The return is required regardless of whether the value of the gift exceeds the exclusion provided in section 2503.

This section will apply to any tenancy in real property having all the characteristics of a common law tenancy by the entirety, regardless of the term by which such tenancy is described under local property law.

Under the rule in this section, if the husband furnished $30,000 and the wife $10,000 as consideration for the purchase of real property held as tenants by the entirety and, when the property was sold for $60,000, the husband received $35,000 and the wife $25,000, the gift at time of sale would be computed as follows:

Value of husband's interest equals $\$60{,}000 \times \frac{30{,}000}{40{,}000} = \$45{,}000.$

Value of gift equals value of interest minus value of proceeds received.

Gift equals $45,000 minus $35,000 equals $10,000.

The attention of your committee has been directed to the fact that the laws of some States prevent the creation of tenancies by the entirety. They do, however, allow the creation by husband and wife of a joint tenancy with the right of survivorship. While there are some differencies in law between these two types of tenancies, your committee believes that the provisions of this section should apply to joint tenancies with right of survivorship created by husband and wife. Accordingly, the House bill has been amended by the addition of a new subsection (d) providing that for purposes of this section a tenancy by the entirety shall be deemed to include a joint tenancy with right of survivorship created by husband and wife.

Section 2516. Certain property settlements

This section corresponds to section 2516 of the House bill.

Under present law there is substantial uncertainty as to whether a gift may result from transfers to the wife under a property settlement incident to a divorce. The House bill provides that where transfers are made pursuant to a separation agreement and divorce occurs within a reasonable time thereafter, such transfers as are made to a spouse in settlement of his or her marital or property rights or to provide a reasonable allowance for the support of issue of the marriage during minority will be deemed to be transfers made for a full and adequate consideration in money or money's worth.

Your committee believes that the term "reasonable time" appearing in the House bill is too indefinite and will create uncertainty as to the application of the section. Accordingly, this section has been revised to indicate that transfers of property by husband and wife pursuant to a written agreement relative to their marital and property rights or to provide a reasonable allowance for the support of the issue of the spouses during minority will be exempt from gift tax provided that divorce occurs within 2 years after entering into the agreement.

SUBCHAPTER C—DEDUCTIONS

Section 2521. Specific exemption

This section is identical with section 2521 of the House bill.

This section is similar to section 1004 (a) (1) of the 1939 Code. No substantive changes have been made.

Section 2522. Charitable and similar gifts

This section is identical with section 2522 of the House bill and is derived from section 1004 (a) (2) and (b) of the 1939 Code and differs only in minor clerical changes and the omission of certain obsolete material.

Section 2523, Gift to spouse

This section is identical with section 2523 of the House bill.

This section is similar to section 1004 (a) (3) of the 1939 Code. The only substantive changes which have been made are in subsections (e) and (f) (3).

Subsection (e) of this section corresponds to section 1004 (a) (3) (E) of the 1939 Code, which provides an exception to the terminable interest rule in the case of a transfer to a trust where the donee spouse is entitled to all of the income from the transferred property for life and has a power of appointment over the entire property. This subsection will somewhat enlarge the exception by eliminating the requirement that the transfer be in trust and by making it possible for a part of the transferred property to quality for the marital deduction. For example, under the new provisions a transfer to the spouse of a legal life estate with an unlimited power to invade would qualify for the marital deduction if all of the other provisions of the section are satisfied.

Subsection (f) (3) corresponds to section 1004 (a) (3) (F) (iii) of the 1939 Code which provides that if during the calendar year 1942 or after April 2, 1948, certain property held as community property was by the donor and the donee spouse converted into separate property of the donor and such spouse, such separate property shall, for certain purposes, be considered as "held as such community property." Subsection (f) (3) provides that all such conversions taking place during the calendar year 1942 or in succeeding calendar years shall be so treated.

Section 2524. Extent of deductions

This section is identical with section 2524 of the House bill.

This section is similar to section 1004 (c) of the 1939 Code. No substantive change has been made.

SUBTITLE C—EMPLOYMENT TAXES

This subtitle, with conforming changes made necessary by your committee's amendments to subtitle A of the bill, is the same as subtitle C of the bill as passed by the House and contains sections 3101 to 3504, inclusive.

This subtitle consists of a rearrangement and simplification of the taxing provisions (including provisions relating to definitions, exemptions, and certain general provisions) of chapter 9 of subtitle B of the 1939 Code. No substantive changes were made by the House bill in the provisions which appear in this subtitle. With the exception of those general provisions which appear in subtitle C of the bill, the provisions relating to procedure and administration (including penalties) which were contained in chapter 9 of subtitle B of the 1939 Code now appear in subtitle F in both the House bill and your committee's bill.

SUBTITLE D—MISCELLANEOUS EXCISE TAXES

Subtitle D, sections 4001 to 4907, inclusive, as passed by the House, consists of a rearrangement and simplification of the taxing provisions (including provisions relating to definitions, exemptions, and certain general provisions) of subtitles B and C of the 1939 Code (except chs. 7, 9, 15, 26, and 28; subch. B of ch. 25; and pts. VII and VIII of subch. A of ch. 27). The House bill made no substantive changes in the provisions of the 1939 Code which appear in subtitle D. The provisions relating to procedure and administration (including penalties and forfeitures) which were contained in subtitles B and C (with the exceptions noted above) of the 1939 Code appear in subtitle F of the House bill.

Your committee's bill amends this subtitle to conform it to the changes made by the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Congress) in those provisions of the 1939 Code which are incorporated in this subtitle.

SUBTITLE E—ALCOHOL, TOBACCO AND CERTAIN OTHER EXCISE TAXES

CHAPTER 51—DISTILLED SPIRITS, WINES AND BEER

GENERAL COMMENT

This chapter corresponds to chapter 51 of the House bill and represents a basic rearrangement of the provisions of existing law.

(1) The provisions of chapter 26 of the 1939 Code which impose taxes on distilled spirits, wines, and beer, including related administrative provisions, have been incorporated in part I of subchapter A.

(2) The provisions of chapter 27 of the 1939 Code, "Occupational Taxes," insofar as they relate to liquor have been rearranged and incorporated as part II of subchapter A.

(3) The provisions in chapter 26 of the 1939 Code, relating to the establishment and operation of distilleries, internal revenue bonded warehouses, rectifying plants, industrial alcohol plants, bonded wineries, and breweries, have been incorporated into separate subchapters B through G, and subchapter H has been included for miscellaneous plants and warehouses.

(4) Subchapter I contains the miscellaneous general provisions applicable to the various types of establishments.

(5) The penalty provisions contained in chapters 26 and 27 of the Internal Revenue Code of 1939 relating to liquor, have been separated from the substantive requirements and incorporated in subchapter J.

The provisions of this chapter relating to wine and beer constitute a substantial revision and modernization of the principal sections of the 1939 Code relating to these products.

The provisions of this chapter pertaining to distilled spirits constitute a rearrangement of the provisions of existing law with such modernizing revisions as it has been possible to make at this time.

The following sections relating to distilled spirits which appear in the 1939 Code have been omitted in their entirety:

(1) Section 2824. Exemption of small distilleries from certain requirements: No distilleries currently operate under this section and it is impracticable due to the cost of supervising such operations.

(2) Section 2835. Vinegar factories operated prior to March 1, 1879: No plants now operate under this section and it is therefore completely obsolete.

(3) Section 2837. Exemptions of alcohol from restrictions of section 2836: The exemption referred to is unnecessary since such exemption is covered by section 5306.

(4) Section 2840. Fermenting tubs: This section has been waived by regulations pursuant to section 2817 (b) of existing law and is considered obsolete and unnecessary.

(5) Section 2845. Special return of number of barrels distilled: This section is obsolete and unnecessary. All required information relating to the production of spirits by distillers can be obtained under section 5197.

(6) Section 2849. First fermenting period: This section has been waived by regulations under authority of section 2817 (b) of existing law and is considered obsolete. Section 5191 sufficiently provides for the commencement of operations by distillers.

(7) Section 2851. Reduction of producing capacity: This section has been waived by regulations under authority of section 2817 (b) of existing law and is obsolete. Section 5191 covers supervision and resumption of operations.

(8) Section 2860. Limitation on purchases by rectifiers and dealers: This section has unduly interfered with the return or exchange of merchandise by retailers and is not deemed to serve a necessary purpose.

(9) Section 2875. Exemption from provisions of law distinguishing between classes of warehouses: This section is substantially obsolete since there is now only one type of warehouse for the storage of untaxpaid spirits produced at registered distilleries. Certain provisions of this section which are still current have been retained in sections 5231 and 5246 (i. e., authority for transfers in bond between warehouse, and specification of one type of warehouse).

(10) Section 3180. Distilleries erected prior to July 20, 1868: Since no such distilleries are now operating, this section is obsolete and has been omitted.

(11) Sections 2889, 2890, and 2891 (b) relating to allowances for losses during transportation for export or to manufacturing bonded warehouses were omitted as having been impliedly repealed by the 1942 amendment to section 2901 of existing law; Such losses are covered under section 5011 (a).

(12) Section 3170. Transfer and delegation of powers: This section was omitted as unnecessary in view of the provisions of section 7804, Chapter 80, which makes the provisions of Reorganization Plan numbered 26 of 1950 and Reorganization Plan numbered 1 of 1952 applicable to all functions vested by this Title in any officer, employee, or agency of the Department, and section 7805, which authorizes the Secretary or his delegate to prescribe all the rules and regulations for the enforcement of this Title.

SUBCHAPTER A—GALLONAGE AND OCCUPATIONAL TAXES

PART I—GALLONAGE TAXES

SUBPART A. DISTILLED SPIRITS

Section 5001. Imposition, rate, and attachment of tax

This section corresponds to section 5001 of the House bill. The date April 1, 1954, appearing in subparagraphs (1) and (3) of subsection (a) has been stricken out and the date April 1, 1955, has been inserted in each place in lieu thereof to conform to section 601 (a) (1) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong.,

2d sess., approved March 31, 1954). This section represents existing law with the exception of paragraph (9) of subsection (a), which imposes the tax on imported cordials and liqueurs which has been collected through interpretation of sections 2800 and 3030 of existing law. It was deemed advisable in view of the rearrangement of sections 2800 and 3030 to add this specific provision for the purpose of clarification of existing law regarding the imposition of this tax.

Section 5002. Definitions

Subsection (a) of section 5002 of the House bill made two changes in existing law. The first change was the insertion of the words "from any source or substance" after the clause "Every person who produces distilled spirits." The second change was the deletion of the word "fermented" from the clause "separates alcoholic spirit from any fermented substance." Subsection (a) as adopted by your committee retains the first change made in existing law by the House, but has restored the word "fermented" in the clause from which it was deleted in the House bill. The addition of the words "from any source or substance" to existing law makes it clear that every person who produces distilled spirits is a distiller regardless of the source or substance from which the spirits are produced. Therefore, it is not necessary to omit the word "fermented" to make it clear that producers of alcohol from petroleum and other products are distillers. It is essential that the word "fermented" be reinstated in this section to preserve the established distinction between distillers and rectifiers.

Subsections (b) and (c) of section 5002 are identical with subsections (b) and (c) of the House bill and represent existing law.

Subsection (d) of section 5002 is identical with subsection (d) of the House bill which represents a clarification of the definition of "proof gallon" as contained in section 2809 (d) of existing law. The headnote has been changed from "gallon" to "proof gallon"; the phrase "In all sales of spirits" has been deleted; and the word "proof" has been inserted before the word "gallon" where it first appears in the clause "a gallon shall be held to be a gallon of proof spirits." None of the provisions of law involving taxes on distilled spirits becomes operative by reason of the sales of such spirits in proof-gallon quantities. This definition has been rewritten as an accurate description of a proof gallon.

Section 5003. Exemptions

This section is identical with section 5003 of the House bill and contains cross references to provisions of law which exempt distilled spirits from the imposition of the tax imposed by section 5001.

Section 5004. Lien for tax

This section is identical with section 5004 of the House bill and represents existing law.

Section 5005. Persons liable for tax

This section is identical with section 5005 of the House bill and represents existing law.

Section 5006. Determination of tax

Your committee has rearranged section 5006 (a) of the House bill into two paragraphs for the purpose of clarity.

This amendment rearranges section 5006 (a) of the House bill, but does not substantially alter its provisions. The rearrangement of subsection (a) is considered desirable to make it clear that the first and last sentences of subsection (a) are of general application to both imported and domestic distilled spirits.

The parenthetical statement added to paragraph (2) of subsection (a) incorporates the exception provided by existing law for distilled spirits which were 8 years of age or older on July 26, 1936 and which were in bonded warehouses on that date. Since there is currently in internal-revenue bonded warehouses a quantity of such spirits, the exception contained in existing law (sec. 2900 (b) of the Internal Revenue Code of 1939) for such spirits has been reinstated.

Subsections (b), (c), and (d) of sec. 5006 are identical with subsections (b), (c), and (d) of the House bill and represent existing law.

Section 5007. Collection of tax on distilled spirits

This section is identical with section 5007 of the House bill.

Subsection (a), "Tax on domestic distilled spirits," refers to section 5061 for the procedural requirements relative to the payment of tax on domestic distilled spirits.

Subsection (b), "Tax on imported distilled spirits and perfumes containing distilled spirits":

The first and second sentences of paragraph (1), "Distilled spirits" are derived from the first and second sentences of section 2800 (f) of existing law, and the last sentence is a restatement of the last sentence of section 2800 (f) of existing law. The first sentence of section 2800 (f) of existing law has been simplified to correspond with a similar provision of section 2800 (a) (3) of existing law, relating to imported perfumes.

Paragraph (2), "Perfumes containing spirits" is existing law. See the second sentence of section 2800 (a) (3).

Subsection (c), "Payment of tax on alcoholic compounds from Puerto Rico and Virgin Islands" represents a simplification of the procedural provisions relative to collection of tax in the first sentence and the last sentence of section 2800 (a) (4) of existing law. The requirement for collection at the port of entry was deleted and provision was made for the collection under such regulations as the Secretary or his delegate may prescribe. This will permit regulations to provide for the payment of tax either in Puerto Rico or at the port of entry into the United States. See section 3360 (b) of existing law.

Subsection (d), "Tax on alcohol," corresponds to section 3112 (b) of existing law. This subsection makes applicable to domestically produced alcohol, and alcohol imported for industrial purposes under section 5311 (derived from sec. 3125), the method of tax payment prescribed for distilled spirits generally.

Subsection (e), "Assessment for deficiencies in production and excess of materials used":

Paragraph (1), "Requirement," is existing law. See section 2846 (a).

Paragraph (2), "Relief from assessment," is existing law. See section 2847 (a).

Subsection (f) contains cross references to other provisions of law relating to assessment and payment of tax on distilled spirits.

Section 5008. Strip stamps for distilled spirits

This section corresponds to section 5008 of the House bill, with the following exceptions:

1. Your committee has amended the House bill by eliminating the charge of 1 cent per stamp (one-quarter cent in the case of stamps for containers of less than one-half pint) made by existing law for strip stamps for containers of distilled spirits. This means that such stamps will be furnished to bottlers and importers of distilled spirits without charge. The action taken by your committee in this regard is consistent with similar action in eliminating the charge for stamps for beer barrels or kegs and for packages of tobacco. These stamps are not tax stamps, but are for the purpose of authenticating the package and protecting the revenue by supplying a simple and immediate means of ascertaining whether the distilled spirits have been legally produced and bottled or legally imported in compliance with the provisions of the internal revenue laws. Since the provisions of section 5008 of the House bill, which related to redemption of strip stamps, will no longer be applicable in view of the elimination of the charge for these stamps, such redemption provisions have been deleted.

2. In addition, your committee deleted from paragraphs (a) (1) and (b) (1) the requirement that stamps be affixed to containers in such manner as to be destroyed upon opening the bottle and substituted the requirement that the stamps be affixed in such manner that they would be broken when the bottle is opened. The reason for this change is that stamps are required to be destroyed when the containers are emptied.

3. Your committee also made a clarifying change in section 5008 (b) (1) (C) exempting from the provisions of this subsection distilled spirits required to be stamped under internal revenue or customs laws and regulations. This change is for the purpose of clarifying the exemptions under existing law provided for casks or other bulk packages of imported distilled spirits stamped under 20 Statute 342 (19 U. S. C. 467) and to clarify the exemption of alcohol bottled in alcohol bonded warehouses and stamped pursuant to internal revenue laws and regulations.

The basic requirements relating to strip stamps for distilled spirits contained in the House bill were retained. Subsection (a) relates to strip stamps for distilled spirits bottled in bond and is derived from section 2903 of existing law. The specific requirement in existing law that the bottled-in-bond stamp denote the quantity of distilled spirits contained in the bottle was eliminated and provision made that the Secretary or his delegate may prescribe the information to be shown on such stamp. The elimination of the denomination will permit more flexible use of stamps and simplify accounting procedure.

Subsection (b), relating to stamps for other containers of distilled spirits, is derived from section 2803 of existing law. Under existing law this stamp evidenced the payment of the tax. However, due to the authorization for payment by return, such stamps will no longer necessarily evidence taxpayment. The stamps will, however, evidence that the tax has been determined and that all applicable provisions of law relating to the bottling of spirits (not bottled in bond) have been complied with. Paragraph (b) (1) makes three additional changes in existing law. The first change is the deletion of the provision that the stamps denote the quantity of distilled spirits. This change is consistent with the similar change made with regard to bottled-in-bond strip stamps. The second change is the insertion of the requirement that the stamp be affixed in such manner as to be broken when the container is opened. This change makes the provisions of subsection (b) consistent with the provisions of subsection (a), relating to bottled-in-bond strip stamps. The third change in paragraph (1) of subsection (b) is the inclusion in the exemption from the requirements of this subsection in item (E) of spirits bottled especially for export with benefit of drawback. Stamps provided for under this subsection have been required only for taxpaid spirits intended for domestic use.

Section 5009. Stamps for distilled spirits withdrawn for exportation

This section represents a revision of section 5009 of the House bill. Your committee has amended the House bill to eliminate the charge made under existing law for stamps used on distilled spirits withdrawn for exportation. Such stamps have been charged for at the rate of 10 cents per stamp except that stamps for wooden packages containing metallic cans have been charged for at the rate of 5 cents per stamp. These stamps are not tax stamps. They denote the legal withdrawal of such spirits from the internal revenue bonded warehouse for exportation. It is the view of your committee that these stamps should be furnished to the exporters without charge. This action is consistent with the elimination of the charge for strip stamps for distilled spirits.

Since subsection (c) related solely to the charge for stamps, this subsection has been eliminated and the provisions of subsections (a) and (b) as contained in the House bill have been simplified and combined in a new subsection (a). The revised subsection (a), with the exception of the elimination of the charge for the stamps, contains in substance the provisions of subsections (a) and (b) of the House bill and represents existing law, except that it has been changed to conform with the authorization in section 5247 (c), which provides for the filling of packages from the distiller's original casks or packages.

Section 5010. Miscellaneous stamp provisions

This section is identical with section 5010 of the House bill.

Subsection (a), "Issue for restamping," is existing law. (See sec. 2802 (a).)

The first clause of subsection (b), "Accountability," is derived from the first clause of the first sentence of section 2802 (b) (1) of existing law. The last clause of the subsection supplants detailed instructions and will permit the Secretary or his delegate to prescribe regulations for use of, and accounting for, such stamps.

Subsection (c), "Effacement of stamps and brands on emptied packages," is existing law. (See sec. 2866.)

Subsection (d) contains cross references to other provisions of law relating to stamps for distilled spirits packages.

Section. 5011. Abatement, remission, refund, and allowance for loss or destruction of distilled spirits

This section is identical with section 5011 of the House bill.

Subsection (a) Distilled spirits lost or destroyed in bond:

Subparagraph (A) of paragraph (1), "Extent of loss allowance," is existing law. (See sec. 2901 (a) (1).)

Subparagraph (B), "Voluntary destruction," represents a major change in existing law. Existing law (sec. 2901 (a)) provides that tax will be collected on distilled spirits voluntarily destroyed, unless such spirits are unfit for beverage purposes and the destruction is authorized. Under this paragraph and subsection (b) there is no condition that spirits must be unfit for beverage purposes to permit voluntary destruction without payment of tax.

Paragraph (2), "Proof of loss," is existing law. (See sec. 2901 (b).)

Paragraph (3), "Refund of tax," is existing law (see sec. 2901 (c)), except that the text has been revised by striking the words "after the tax was paid" at the end of the last sentence and inserting in lieu thereof the words "after the tax was determined as provided in section 5006 (a), and the spirits removed from bond." This revision is necessary to conform to the method of tax payment by return. Under existing law, tax is paid prior to the time of removal from bond. It has not been lawful to refund such tax where spirits are lost or destroyed after such payment of tax. Since, under provisions of sections 5006 and 5061 tax may be determined prior to removal but, in some instances, not paid until after removal, it is necessary, in order to preserve the original intent of the law, to revise this paragraph to prohibit remission or refund of tax after determination of the tax and removal of the spirits.

Paragraph (4), "Insurance coverage," is existing law. (See sec. 2901 (d).)

(b) "Voluntary destruction." Existing law (sec. 2901 (a)) provides that tax will be collected on distilled spirits voluntarily destroyed unless such spirits are unfit for beverage purposes and the destruction is authorized. Under this subsection there is no condition that spirits must be unfit for beverage purposes to permit voluntary destruction without payment of tax.

Subsection (c), "Loss or destruction of alcohol," is existing law (see sec. 3113 (a)) except that the parenthetical statement "(produced at an industrial alcohol plant or imported under sec. 5311)" has been inserted following the words "Whenever any alcohol" at the beginning of the subsection, and the words "under existing law" were deleted in the phrase "may remit or refund any tax incurred under existing law upon such alcohol". The parenthetical insertion is made to distinguish between alcohol produced at industrial alcohol plants or imported and high proof spirits produced at distilleries, in order that the loss provisions of the subsection may not be construed as applying to such spirits produced at registered distilleries. The deletion of the words "under existing law" is made for the purpose of clarity.

Subsection (d) contains cross references to other provisions of law pertaining to allowance for loss while in bond.

Section 5012. Drawback

This section is identical with section 5012 of the House bill.

Subsection (a), "Drawback on exportation of distilled spirits in distillers' original packages," is a simplification of section 2887 of existing law. Details as to forms, procedures, and customs requirements have been left to regulations. This will permit a more efficient and less costly system of administration. Certain existing detailed requirements have been found to be obsolete and unnecessary.

Subsection (b), "Cross references," contains cross references to other provisions of law relating to drawback on distilled spirits and alcohol.

SUBPART B. RECTIFICATION

Section 5021. Imposition and rate of tax

This section is identical with section 5021 of the House bill.

Subsection (a), "Rectified spirits and wines," is existing law (see sec. 2800 (a) (5)). The proviso relating to the production of gin and vodka has been omitted for incorporation in section 5025 (b). The use of the word "imposed" rather than "levied, assessed, collected, and paid" is intended only as a modernization of language.

Subsection (b), "Change in proof or volume," is existing law (see sec. 2801 (b)) except that the text has been revised by striking the word "paid" in the two places it appears in existing law (sec. 2801 (b)), and inserting in lieu thereof the word "determined." This revision is necessary to conform to the authorized method of taxpaying by returns. Under existing law, tax is paid at the time of the completion of the process of rectification. It has not been lawful to change the proof or volume of a rectified product after such taxpayment. Since, under the provisions of sections 5020 and 5061 tax may be determined at the time the process of rectification is completed, but in some instances, not paid at such time, it is necessary, in order to preserve the original intent of the law, to revise this subsection to prohibit change in proof or volume of the product after the rectification tax has been determined.

Section 5022. Tax on cordials and liqueurs containing wine

This section corresponds to section 5022 in the House bill except that it has been revised to conform to section 601 (a) (4) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954) by striking out "April 1, 1954" each place it appears and inserting in lieu thereof "April 1, 1955."

The section represents a substantial change in existing law. It is derived principally from section 3030 (a) (2) of the existing law. Since the products covered are primarily rectified products, this provision has been included in this subpart.

The first important change from existing law is the deletion of the listing of fortified wines (and brandies used therein) and the insertion of the words "and not sold as wine, which contain more than 2½ percent by volume of wine of an alcoholic content in excess of 14 percent by volume (other than bottled cocktails). This change will permit the imposition of the tax equally upon cordials, liqueurs, etc., containing unfortified wines of an alcoholic content in excess of 14 percent by volume and upon such cordials, liqueurs and liquors containing fortified wines of an alcoholic content in excess of 14 percent by volume.

Another important change in this section from existing law is the changing of the taxable unit to a "wine gallon" in lieu of the former "each one-half pint or fraction thereof." The new rate stated for these compounds has been calculated so that the revenue yield will be the same under the new provisions as it has been under section 3030 (a) (2).

The tax imposed by this section is in lieu of the rectification tax imposed by section 5021.

Section 5023. Tax on blending of beverage brandies

This section is identical with section 5023 of the House bill.

The section is existing law (see sec. 2801 (e) (5)), except that the text of the first proviso of the section has been revised by striking from the end thereof the clause "such tax to be paid by rectified spirits stamps affixed to the packages at the time of withdrawal," and substituting therefor the clause "such tax to be determined at the time of withdrawal and paid under such regulations as the Secretary or his delegate shall prescribe." This change was made to conform to the provision of sections 5026 and 5061 (a), relative to the determination of tax and the payment thereof by return.

Section 5024. Definition

This section is identical with section 5024 of the House bill and consists of cross references to other definitions involving rectification.

Section 5025. Exemption from rectification tax

This section is identical with section 5025 of the House bill.

Subsection (a), "Absolute alcohol," is existing law. See section 2801 (c) (2).

Subsection (b), "Production of gin and vodka," is existing law. See proviso at end of section 2800 (a) (5).

Subsection (c), "Rectifying spirits in course of original distillation," is existing law. See proviso at end of section 3254 (g).

Subsection (d), "Redistillation of spirits by distillery," is existing law. See last sentence of section 2883 (e).

Subsection (e), "Blending straight whiskies, pure fruit brandies, or wines," represents existing law (see sec. 2801 (c) (1)), relating to blending of straight whiskies, blending of fruit brandies and blending of wines to commercial standards. The exempting provision of section 2801 (c) (1) relating to cordials and liqueurs taxable under existing section 3030 (a) (2) has been omitted here, since the taxing provisions of existing section 3030 (a) (2) have been incorporated in this subpart at section 5022.

Another change is in the first sentence of this subsection, where the parenthetical phrase "(other than caramel)" has been inserted after the words "coloring or flavoring matter" in the qualifying statement relative to the blending of pure fruit brandies. This insertion is consistent with the provisions of existing law (see sec. 3036 (a)) and conforms to present practices.

Subsection (f) "Addition of caramel to brandy" is derived from the principle set forth in section 3036 (a) of existing law, which states that win^ spirits shall include commercial brandy which has been colored with burnt sugar or caramel. Subsections (b) and (c) of section 3036 of existing law extend these provisions to citrus fruit and brandy and other fruit brandy. Under these provisions of law it has been standard practice to permit, under regulations, the addition of a quantity of caramel sufficient to make up deficiencies in color, provided this addition of caramel was done in the distillery or warehouse prior to removal. The exemption herein will apply only to the addition of caramel at the distillery where produced or in the warehouse where stored and will not apply to the addition of caramel at a rectifying plant or any other premises.

(*g*) *Apothecaries.*—This subsection is existing law. (See sec. 3250 (d)).

Subsection (i) contains cross references to provisions of law exempting certain persons and products from special tax as a rectifier and from the rectification tax imposed by this subpart.

Section 5026. Determination and collection of rectification tax

This section is identical with section 5026 of the House bill.

(*a*) *Determination of tax.*—The first clause of paragraph (1) "General" represents a major change from existing law. Rectification tax is now collected at the time the process of rectification is completed. Under the provision of subsection 5026 (b) and section 5061 the tax may be paid by return. Under such a system the rectified products may be gauged, the tax determined, and the products bottled or packaged and removed from the rectifying plant prior to the time of actual payment of the tax. Accordingly, this new sentence will provide for the determination of the tax rather than for the payment of the tax as has been provided in existing section 2800 (a) (1) (A). The remainder of the paragraph is derived from the existing section 2800 (a) (1) (A) in respect to the method and equipment to be used in ascertaining the tax.

Paragraph (2) "Unauthorized rectification" incorporates the policy under existing law of asserting and collecting rectification tax in the case of unauthorized rectification. It is intended that the provision of this paragraph will preclude any person conducting an unauthorized rectifying process from taking advantage of a deferred payment system.

Subsection (b), "Taxes on rectified spirits, wines and cordials, or liqueurs," refers to section 5061 for the procedural requirements relative to the payment or collection of the rectification tax imposed under this subpart.

Section 5027. Stamp provisions applicable to rectifiers

This section is identical with section 5027 of the House bill.

Subsection (a), "Exchange of wholesale liquor dealers' stamps for rectified spirits stamps," is existing law. See section 2802 (c).

Subsection (b), "Cross references," contains references to other provisions of law relating to the stamping of rectified products.

Section 5028. Cross references

This section is identical with section 5028 of the House bill and refers to penalties applicable to violations of the provisions of subpart B.

SUBPART C—WINES

Section 5041. Imposition and rate of tax

This section corresponds to section 5041 of the House bill but with the following changes:

(1) The section has been revised to conform with section 601 (a) (3) and (4) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954) by striking out the date "April 1, 1954" each place it appears and inserting in lieu thereof "April 1, 1955".

(2) The reference to "rice wine" in the second line of subsection (a) has been deleted. The House bill proposes to impose the wine tax on such products. Heretofore, sake, rice wines, and similar products have been taxed as beer. A small amount of rice wine is made in Hawaii and a small amount is imported. Most of the sake and rice wine is sold in Hawaii to persons of Japanese extraction. In classifying the product as wine the tax rate would be raised from approximately 29 cents per gallon (under the beer tax rate) to 67 cents per gallon, the rate for wine containing more than 14 percent but not more than 21 percent of alcohol. These products usually contain from 16 to 18 percent of alcohol. At the present time sake is being produced only in the Territory of Hawaii by three breweries. Your committee feels that such an increase in rate of tax at this time would unduly burden this comparatively small industry and cause unwarranted hardship. Sake is being included in the definition of beer in section 5052 (a) in order to bring it clearly within the taxable classification of beer.

The section as amended makes three changes in existing law.

The first change is to impose the tax on champagne and other sparkling wines and on artificially carbonated wine on the "wine gallon" in lieu of the existing imposition on "each one-half pint or fraction thereof," but the rates stated for these wines have been calculated so that the revenue yield will be the same as heretofore. This change is made to establish a uniform taxable unit for all wines.

The second change is to define the term "wine gallon" consistent with other provisions of law establishing the liquid measure equivalent of a gallon, and to clarify the method of computing tax on fractional parts of a gallon.

The third change is in respect to the tax on illegally produced wine. It provides that the tax shall be due on illegally produced wine at the time of production, whether or not the product has been removed for consumption or sale. This will facilitate collection of tax on illegally produced wine, and is consistent with existing administrative construction.

The general provisions regarding taxes on wines and the rates of tax on still wines are the same as in existing law. The use of the word "imposed" rather than "levied, collected, and paid" is intended only as a modernization of language. (See sec. 5022 regarding the tax imposed by existing law (sec. 3030 (a) (2)) on liqueurs, cordials or similar compounds.)

Section 5042. Exemption from tax

This section is identical with section 5042 of the House bill.

The section makes two important changes in existing law (sec. 3030).

The first change is to provide a definite distinction between taxable apple wine and tax-free hard (fermented) cider (usually made during the fall of the year by farmers and sold at the roadside), by permitting exemption from the tax only in the case of cider which is made within prescribed limitations. The enactment of this provision will restore the situation which existed prior to 1936. At that time the revenue laws were amended to specifically refer to "apple wine," thus raising the question whether hard cider (previously not taxed) is taxable. This clarifying provision will remove the uncertainty as to the status of hard cider and will permit further clarification by regulations.

The second important change is to authorize universities and certain other institutions to produce, receive, blend, treat, and store wine for experimental purposes but not for consumption or sale. Some universities and colleges have installed courses in the production and treatment of wines. The production, receipt, etc., of wine for experimental purposes and the withdrawal of wine spirits without payment of tax for such purposes will be somewhat similar to the withdrawal of alcohol under existing law for use by universities and colleges.

The provision in existing law authorizing the tax-free production of wine for family use is retained.

Section 5043. Collection of taxes on wines

This section is identical with section 5043 of the House bill.

The section has two changes in existing law (sec. 3030 (b)).

The first change is to establish the joint and several liabilities of all persons concerned with the illegal production, importation, or possession of wine. Under existing law, the tax on illegally produced or imported wine can be collected only from the producer or importer. This section makes it possible to collect the tax from the person possessing the illegal wine. This will facilitate the collection of tax on such wine and is consistent with section 5041 (d).

The second change concerns the method of tax collection. Under existing law the tax on wine is collected by stamp. This section provides for the collection of the tax by return upon the issuance of regulations by the Secretary or his delegate. The collection of the tax by return will be consistent with the method of collection of other excise taxes.

Provisions in existing law regarding persons liable for the tax on wine removed from bond or customs custody are retained.

Section 5044. Refund of tax on unmerchantable wine

This section is identical with section 5044 of the House bill.

The section is new. It makes provision for refund, credit, or other tax relief, upon delivery of unmerchantable domestic champagne or other sparkling wine or artificially carbonated wine to a bonded wine cellar. Similar provision is not made in respect to still wines. Where champagne or other effervescent wines have lost their effervescence, contain sediment, or have become cloudy, it is not feasible to place them in a marketable condition. If the wines have not already lost their effervescence, a process of reconditioning will result in the loss of effervescence, and reduce the value of the product to that of a still wine, which is substantially less than that of an effervescent wine. If the tax has been paid, the claim for refund or credit must be filed by the proprietor of the bonded wine cellar to which the effervescent wine is delivered for destruction or conversion into still wine. If such effervescent wine is returned to a bonded wine cellar before payment of the tax by return, as authorized under section 5061, the claim for relief from tax must be filed by the proprietor of the bonded wine cellar from which the wine was removed for a taxable purpose. The burden of proof in all such cases is with the claimant. Refund, credit, or relief will be granted only in respect to effervescent wines removed subject to tax on or after the date of enactment of this chapter.

Section 5045. Cross references

This section is identical with section 5045 of the House bill and is a cross-reference section only.

SUBPART D—BEER

It is the intention of your committee that wherever in this subpart the Secretary or his delegate is authorized to prescribe regulations, such authority shall be exercised only to the extent necessary to protect and insure collection of the revenue.

Section 5051. Imposition and rate of tax

This section corresponds to section 5051 of the House bill except that it has been revised to conform with section 601 (a) (5) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954) by striking out "April 1, 1954" each place it appears and inserting in lieu thereof "April 1, 1955".

Subsection (a), "Rate of tax," contains no change in substance of existing law (sec. 3150 (a)) with the sole exception that the listing of lager beer, ale, porter, and other similar fermented liquor, containing one-half of 1 percent, or more, of alcohol, has been deleted here and the word "beer" substituted therefor, since beer is defined in section 5052 to include lager beer, ale, porter, and other similar fermented liquor. The use of the word "imposed" rather than "levied and collected" is intended only as a modernization of language.

Subsection (b), "Assessment upon materials used in production in case of fraud," is existing law. (See sec. 3150 (c).)

Section 5052. Definition

This section corresponds to section 5052 of the House bill except that subsection (a) has been amended to include sake in the definition of "beer."

Subsection (a) defines "beer" to include ale, porter, stout, lager beer, and other similar fermented liquors (including sake or similar products). (See sec. 3150 (a).)

Subsection (b), "Gallon," represents existing law (sec. 3160) except that the words "wherever used in the internal revenue law relating to beer, lager beer, ale, porter, and other similar fermented liquors," have been omitted and the phrase "wherever used in this subpart" has been substituted therefor, and the phrase "wine gallon" has been deleted as misleading to the public when used with regard to beer.

Subsection (c), "Brewer," is a cross reference to the definition of the word "brewer."

Section 5053. Exemptions

This section corresponds to section 5053 of the House bill with the exception that your committee has eliminated the proviso at the end of subsection (a), which provided that beer delivered to customs custody shall be deemed to be exported for the purposes of this section. The deleted language is unnecessary and would require the customs service to take custody of beer to be exported. This would impose a duty on the customs service which would serve no useful purpose. It is not intended by this change to require proof of landing as evidence of exportation. The elimination of the proviso merely leaves to regulations the determination of when the beer shall be deemed to be exported, and under such regulations beer could be deemed to be exported when laden for export in accordance with customs regulations.

With the above exception subsection (a) follows the House bill and represents existing law, except that the provisions for withdrawal for export to storage warehouses and the restriction on the drawback of tax on exported fermented liquors contained in existing law have been deleted. These deletions are made because it has been found that warehouses, depots, or other places of storage are no longer used for the storage of beer withdrawn in casks from breweries without payment of tax, and specific provision has been made in section 5006 for drawback on exported beer. Subsections (b), (c), and (d) are the same as the House bill.

Subsection (b), "Removals when unfit for beverage use," is existing law. (See sec. 3153 (c).) The statutory requirements relative to the types of vessels to be used and marks, brands, and stamps thereon have been omitted and there has been substituted therefor a provision for the removal under regulations to be prescribed by the Secretary or his delegate.

Subsection (c), "Removals for laboratory analysis," is consistent with the provisions of the existing law regarding the removal of samples of wine and wine spirits.

Subsection (d), "Removal as supplies for certain vessels and aircraft," is a cross-reference to the provisions of section 309 of the Tariff Act of 1930 (19 U. S. C. 1309) relating to the use of certain articles as supplies on certain vessels and aircraft.

Section 5054. Persons liable for tax

This section is identical with section 5054 of the House bill and represents existing law.

Section 5055. Determination and collection of tax on beer

This section corresponds to section 5055 of the House bill with the exception that your committee has eliminated the provision that stamps or other devices evidencing the tax or indicating compliance with the provisions of this chapter (affixed to hogsheads, barrels, or kegs of beer at the time of removal) shall be sold to brewers for a sum sufficient to defray the expense of preparation. This change means that stamps or other devices (if required, by regulations) would be furnished to brewers without charge. The third and fourth sentences of this section, relating to the redemption of such stamps, as they appeared in the House bill were deleted and provision made that the Secretary or his delegate shall by regulations prescribe the manner by which such stamps or other devices shall be supplied, affixed, and accounted for. The action taken by your committee with regard to the stamps or devices for beer kegs, etc., is consistent with similar action with regard to strip stamps for containers of distilled spirits and for package stamps for tobacco.

Existing law (secs. 3150 (b) (2) and 3157 (a)) requires that the tax on all beer must be paid by stamp when sold or removed for consumption or sale. This section requires the tax on beer to be determined upon sale or removal for consumption or sale. Under existing law tax stamps are required to be affixed to hogsheads, barrels, or kegs of beer at the time of removal. A provision has been made in this section to authorize the Secretary or his delegate, whenever he finds it necessary for the protection of the revenue, to require stamps or other devices to be affixed to hogsheads, barrels, or kegs of beer at the time of removal. These stamps would be in lieu of the tax stamps and would be similar to the strip stamps used for containers of distilled spirits.

Section 5056. Drawback of tax

This section is identical with section 5056 of the House bill.

The section represents a major change in the existing law. It authorizes drawback of tax on taxpaid beer which is exported. This is now specifically prohibited (sec. 3153 (b)). This provision accords to brewers the same privilege accorded in existing law to distillers, winemakers, and manufacturers of tobacco articles.

Section 5057. Refund and credit of tax, or relief from liability

This section is identical with section 5057 of the House bill.

Subsection (a) authorizes a refund, credit, or remission of tax on beer belonging to a brewer if such beer is returned to the brewery or destroyed under such supervision as may be required by regulations.

Subsection (b) gives the same relief to brewers for beer lost by casualty, except by theft.

Subsection (c) requires claims under this section to be filed within 6 months. A claim will not be allowed if the claimant is indemnified by insurance or otherwise in respect of the tax.

SUBPART E—GENERAL PROVISIONS

Section 5061. Method of collecting tax

This section corresponds to section 5061 of the House bill except that the reference in subsection (a) to January 1, 1955, has been deleted as unnecessary in view of the fact that the provisions of subtitle E do not become effective until January 1, 1955.

Subsection (a), "Collection by return," represents a basic change in the method of collecting taxes on distilled spirits, wines, rectified spirits and wines, and beer. Existing law (secs. 2800, 3030, and 3150) provides that taxes on such articles will be paid by stamp, on the basis of individual withdrawals and at the time of such withdrawals. This subsection will authorize the payment of such taxes by return and will permit the Secretary or his delegate to prescribe, by regulations, the period for which a return shall be filed, the time for filing such return, the information to be shown thereon, and the time for the payment of the tax. A proviso in this subsection will continue the present method of taxpayment until regulations to provide for the payment of taxes by return have been issued by the Secretary or his delegate.

Subsection (b), "Discretionary method of collection," substantially represents existing law (sec. 3172 (a)). This provision authorizes alternate methods for the collection of tax where it is deemed necessary.

Subsection (c), "Applicability of other provisions of law," is derived from the last sentence of section 3172 (a) of existing law.

Section 5062. Refund and drawback in case of exportation

This section is identical with section 5062 of the House bill and represents existing law.

Section 5063. Floor stocks tax refunds on distilled spirits, wines, cordials, and beer

This section corresponds to section 5063 of the House bill except that it has been revised to confrom to section 601 (b) (1) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954) by striking out "April 1, 1954" each place it appears and inserting in lieu thereof "April 1, 1955" and by striking out "May 1, 1954" and inserting in lieu thereof "May 1, 1955".

Subsection (a), "General," is existing law (sec. 1656 (a)) with a modification at the end to provide for the filing of a claim within 30 days from the promulgation of the prescribed regulations.

Subsection (b), "Limitations on eligibility for credit or refund," represents the provisions of existing law (sec. 1656 (b)) except that clause (2) has been omitted. This clause would require proof that, as to any article on which refund is claimed, such article is sold at a price to reflect the reduced tax rate. This requirement is impracticable to administer, or to comply with, and would constitute a heavy and costly administrative burden upon the Government and upon any person desiring refund under the provisions of subsection (a).

Subsection (c) "Other laws applicable" is existing law. (See sec. 1656 (c).)

Section 5064. Territorial extent of law

This section is identical with section 5064 of the House bill.

The section is existing law (sec. 3174), except that it has been modified to include wines, in addition to distilled spirits and beer.

Section 5065. Cross references

This section is identical with section 5065 of the House bill.

The section clarifies the applicability of subtitle F, relating to procedure and administration, to this subtitle.

Part II—Occupational Tax

SUBPART A—RECTIFIER

Section 5081. Imposition and rate of tax

This section is identical with section 5081 of the House bill and represents existing law.

Section 5082. Definition of rectifier

This section is identical with section 5082 of the House bill.

The section is existing law (sec. 3254 (g)), except that the proviso, relating to the purifying and refining of spirits in the course of original and continuous distillation, has been omitted and is stated at section 5025 (c) under the headnote "Refining Spirits in Course of Original Distillation."

Section 5083. Exemptions

This section corresponds to section 5083 of the House bill and makes reference to provisions of law-making exemptions from rectification tax or from special tax as a rectifier. Your committee has made an amendment to paragraph (13) by changing the reference to section 5392 to "5391". This amendment is merely a technical correction.

Section 5084. Cross references

This section is identical with section 5084 of the House bill.

The cross references contained in this section are to general provisions of law relating to rectification taxes, establishment and operations of rectifying plants, and the penalties and forfeitures relative thereto.

SUBPART B—BREWER

Section 5091. Imposition and rate of tax

This section is identical with section 5091 of the House bill and represents existing law.

Section 5092. Definition of brewer

This section is identical with section 5092 of the House bill.

The section is existing law (sec. 3254 (d)), except that the word "beer" has been substituted for the words "fermented liquors of any description, for sale, from malt, wholly or in part, or from any substitute therefor." This change is made to conform to new section 5052 (a), which defines "beer" as including all such liquors.

Section 5093. Cross references

This section is identical with section 5093 of the House bill and contains references to provisions of law exempting brewers from special tax incurred by selling beer.

SUBPART C—MANUFACTURERS OF STILLS

Section 5101. Imposition and rate of tax

This section is identical with section 5101 of the House bill and represents existing law.

Section 5102. Definition of manufacturer of stills

This section is identical with section 5102 of the House bill and represents existing law.

Section 5103. Exemptions

This section is identical with section 5103 of the House bill.

The section makes reference to the provision of existing law (sec. 3103) exempting proprietors of industrial alcohol plants from special tax as manufacturers of stills and the tax on stills manufactured.

Section 5104. Method of payment of tax on stills

This section is identical with section 5104 of the House bill and represents existing law.

Section 5105. Notice of manufacture of and permit to set up still

This section is identical with section 5105 of the House bill.

Subsection (a), "Requirement," is existing law. (See sec. 2818 (a).)

Subsection (b), "Penalty," makes reference to the penalty provisions relating to failure to give notice of manufacture or failure to register stills.

Section 5106. Drawback

This section is identical with section 5106 of the House bill.

The section makes no change in existing law (sec. 3250 (j) (3)) other than to add the words "and worms" immediately after the word "stills." Because of the omission of the words "and worms" from the provisions of the existing law, it has not been possible to allow drawback of tax paid upon worms exported. The change in this section will permit equal treatment in respect of any taxable distilling apparatus exported.

SUBPART D—WHOLESALE DEALERS

Section 5111. Imposition and rate of tax

This section is identical with section 5111 of the House bill and represents existing law.

Section 5112. Definition of wholesale dealers

This section is identical with section 5112 of the House bill and represents existing law.

Section 5113. Exemptions

This section is identical with section 5113 of the House bill.

Subsection (a), "Distillers selling spirits of own production," is a restatement of existing law (sec. 3250 (a) (4)) except that the statement "to which the taxpaid stamps are affixed" was deleted due to the change in the method of taxpayment from payment by stamp to payment by return. Under the method of payment of the tax by return, taxpaid stamps would not be affixed to such barrels at the time of withdrawal. In order to preserve the intent and effect of this exemption the limitation was inserted, making it applicable to sales only "after determination of the tax."

Subsection (b), "Brewer selling in barrels, etc.," is existing law (sec. 3250 (d) (3). The world "obliged," appearing in the clause "no brewer shall be obliged to pay special tax" which begins the subsection, has been changed to "required," so that the clause now reads "no brewer shall be required to pay special tax." This change brings the language into conformity with the language of other similar provisions of law.

Subsection (c), "Winemakers selling wines of own production," is existing law. See section 3250 (g).

Subsection (d) "Casual sales."

Paragraph (1), "Sales by creditors, fiduciaries, and officers of court," is existing law. See section 3251 (a)

Paragraph (2), "Sales by retiring partners or representatives of deceased partners to incoming or remaining partners," is existing law. See section 3251 (b).

Subsection (e), "Cross references," contains references to provisions of law relating to exemption of retail dealers from wholesale liability.

Section 5114. Records

This section corresponds to section 5114 of the House bill. Your committee has amended the section by deleting the term "Government officers" wherever it appears and has substituted in lieu thereof the term "internal revenue officers". This amendment has been made in the interest of uniformity of language. Numerous other provisions of chapter 51 make provision for supervision or inspection by internal revenue officers. The term "Government officers" in this section was intended to refer to "internal revenue officers" and the foregoing change has been made in order that the language of the various provisions will be consistent.

Subsection (a), "Requirements," is derived from section 2857 of existing law. Several changes have been made. The phrase "at his place of business covered by his special tax stamp," in existing law, has been deleted. Existing law, with the phrase in it, has been construed as limited to wholesale dealers who have purchased special tax stamps. The phrase was, therefore, deleted to make the requirements of this section applicable to all wholesale liquor dealers, regardless of whether they have special tax stamps.

Existing law provides that every wholesale liquor dealer "shall keep daily" a record of distilled spirits received and disposed of by him. This requirement has been retained. However, the existing statutory requirements relating to transcripts and summaries has been changed to require dealers to submit transcripts, summaries, or records, as the Secretary or his delegate may require. The Secretary or his delegate may thus put into effect the requirements of the section to the extent required by current conditions and problems.

The time during which records are required to be kept has been reduced from 4 years to 2 years to conform with other similar requirements of the code. The requirements with respect to records to be kept by rectifiers has been made a part of section 5285 (b).

Subsection (b), "Exemption of States," is existing law. See section 2858.

Subsection (c), "Cross references," contains references to provisions of law relating to wholesale records to be kept by dealers and rectifiers and to the penalties for violation of section 5114.

Section 5115. Marking and stamping oj packages filled on premises of wholesale dealers

This section is identical with section 5115 of the House bill.

Subsection (a), "Requirements," is existing law. See section 2863.

Subsection (b), "Penalty," makes reference to the penalty provisions of law relating to noncompliance by wholesalers to the provisions of this section.

Section 5116. Sign required on premises

This section is identical with section 5116 of the House bill.

Subsection (a), "Requirements," is a simplification of existing law (section 2831). The specific requirements concerning the length, width, and color of the lettering of the required sign have been omitted in this subsection and provision made for the Secretary or his delegate to prescribe such standards by regulation.

Subsection (b), "Penalty," makes reference to the penalty for failure to post the prescribed sign.

SUBPART E—RETAIL DEALERS

Section 5121. Imposition and rate of tax

This section is identical with section 5121 of the House bill and represents existing law.

Section 5122. Definitions

This section is identical with section 5122 of the House bill and represents existing law.

Section 5123. Exemptions

This section is identical with section 5123 of the House bill.

Subsection (a), "Brewers selling in one-eighth barrel packages," is existing law (section 3250 (e) (4)), except that since tax on beer may be paid by return, the qualification relative to the sale in "stamped packages" has been changed by deleting the words "original stamped" from the description of the package.

Subsection (b) "Business conducted in more than one location":

Paragraph (1) "Retail dealers at large" is existing law. See section 3255 (a).

Paragraph (2) "Retail dealers on trains, aircraft, and boats" is existing law (section 3255 (b)) except that specific provision has been made to include "aircraft." The term "aircraft" is defined as a vessel. Regulations issued pursuant to the provisions of existing section 3255 (b) have applied to the business of retail dealers on aircraft as well as on other vessels.

Paragraph (3) "Dealers making sales on purchaser dealers' premises": This paragraph is existing law (sec. 3255 (c)) with the following exception. The phrase "covered by the stamp issued to him to denote the payment of the special tax imposed upon such dealers" has been omitted. Under the existing law, it has been held that where a brewer sells bottled beer, without prior orders having been given and received at the brewer's premises, at the places of business of various dealers along an established route and where the purchasing dealer had not been issued a stamp for the current fiscal year, such sales to the purchaser were in violation of the provisions of section 3255 (c), and rendered the brewer liable to special tax as a dealer at each of the premises where sales were so made. The omitted provision of law has been impracticable to administer and inequitable in result.

Subsection (c) "Sales by retail dealers in liquidation": This is existing law (sec. 3251 (c)) except that the last sentence (of sec. 3251 (c)) has been omitted since the section referred to (sec. 2860) is obsolete.

Subsection (d) "Cross references" contains references to special exemptions from wholesale dealers' special taxes.

Section 5124. Records

This section is substantially the same as section 5124 of the House bill.

The first three subsections of this section are existing law. (See subsecs. (a), (b), and (c) of sec. 3252.) Subsection (d) refers to the penalty provisions relative to retail dealers' records.

Your committee has deleted the term "Government officers" where it appears in subsection (b) and has substituted in lieu thereof the term "internal revenue officers". This change has been made in the interest of uniformity of language. Numerous other provisions of chapter 51 make provision for supervision or inspection by internal revenue officers. The term "Government officers" in this section was intended to refer to "internal revenue officers" and the foregoing change has been made in order that the language of the various provisions will be consistent. Your committee has amended subsection (d) of this section by deleting the letter "(d)" following the reference to section 5692. This is a typographical correction only. Section 5692 contains no subsections.

SUBPART F—NONBEVERAGE DOMESTIC DRAWBACK CLAIMANTS

Section 5131. Eligibility and rate of tax

This section corresponds to section 5131 of the House bill and is existing law (sec. 3250 (l) (1) and (2)) except that your committee has eliminated the requirement that the distilled spirits to be used in the manufacture or production of the designated nonbeverage products to be eligible for drawback must be "fully taxpaid.". Your committee has provided that the tax must have been determined on such distilled spirits. Under existing law distilled spirits are taxpaid at the time of withdrawal from bond. However, under the provisions of this bill (see sec. 5061) the tax may be determined upon withdrawal from bond and paid by return at the time prescribed by regulations.

In order to prevent delay in the payment of drawback claims the claimant will no longer be required to establish tax payment but will instead be required to establish that the distilled spirits have been legally withdrawn and the tax thereon determined as provided by law. Since the tax will be collected from the distiller or warehouseman who will be under bond for the payment of such tax it is not anticipated that this change will jeopardize the revenue.

Section 5132. Registration

This section corresponds to section 5132 of the House bill and is existing law (sec. 3250 (l) (3)) except that your committee has amended this section to correspond with the change made in section 5131 (a) relating to the determination of the tax on the distilled spirits used in the designated nonbeverage products.

Section 5133. Investigation of claims

This section is identical with section 5133 of the House bill and is existing law. (See sec. 3250 (l) (4).)

Section 5134. Drawback

This section corresponds to section 5134 of the House bill except that your committee has amended subsection (a) to provide that drawback may be allowed in the case of distilled spirits on which the tax has been determined and which are used as provided in this subpart. This change is consistent with similar changes made in sections 5131 (a) and 5132. Also, the date 1954 which appeared in the House bill has been struck out and the date 1955 has been inserted by your committee to conform to section 601 (b) (4) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess.). With the exception of the amendment made by your committee to conform with the change made in section 5131, this section represents existing law (sec. 3250 (l) (5)).

SUBPART G—GENERAL PROVISIONS

Section 5141. Registration

This section is identical with section 5141 of the House bill and refers to the provisions relating to registration of special taxpayers.

Section 5142. Payment of tax

This section is identical with section 5142 of the House bill and represents existing law.

Section 5143. Returns

This section is identical with section 5143 of the House bill and represents existing law.

Section 5144. Provisions relating to liability for occupational taxes

This section is identical with section 5144 of the House bill.

The section contains provisions pertaining to ownership, location, and changes in ownership and location of businesses subject to special taxes.

Subsection (a) "Partners" is existing law (section 3277).

Subsection (b) "Different Businesses of Same Ownership and Location" represents existing provisions of law (section 3279).

Subsection (c) "Business in More Than One Location" is derived from section 3278 and represents existing law, except that a proviso has been added at the end of the subsection to define the place of business subject to one special tax.

Under existing law, the definition of location has received a limiting construction which in many cases required more than one payment of special tax for a business carried on by the same proprietor in the same general location but divided by streets, canals, public passageways, partitions, etc. Although a slight loss of revenue from special taxpayments may be anticipated due to this change, it is believed that the change corrects inequities in the present law and that it will substantially simplify administration of this provision of law. Under existing law, a brewer whose premises are separated by a public street and who sells beer at locations on the premises separated by the public street, is required to pay special tax as a dealer at each of the locations, although, in fact, he is carrying on but one business of selling his product on his brewery premises. The new provision added at this subsection will permit the carrying on of such a business under one special tax.

Subsection (d) "Death or Change of Location" is existing law. See section 3280 (a).

Subsection (e) "Federal Agencies or Municipalities" is existing law (section 3283).

Section 5145. Supply of stamps

This section is identical with section 5145 of the House bill.

The section is existing law (sec. 3273 (a)) except that references to sections 2802 (a), 3300, 3301, and 3302 of existing law have been omitted and all pertinent provisions relating to stamps have been made applicable to the supplying of special tax stamps under section 5145.

Section 5146. Posting stamps in place of business

This section is identical with section 5146 of the House bill and refers to the provisions relating to posting special tax stamps. (See sec. 3273 (b).)

Section 5147. List of special taxpayers for public inspection

This section is identical with section 5147 of the House bill and refers to the provisions of law relating to lists of special taxpayers for public inspection. (See sec. 3275 (a).)

Section 5148. Application of State laws

This section is identical with section 5148 of the House bill and represents existing law.

Section 5149. Application of subpart

This section is identical with section 5149 of the House bill.

The section derives from section 3282 of existing law and makes applicable the provisions of this subpart to the special taxes imposed under this part and by chapter 53.

SUBCHAPTER B—DISTILLERIES

PART I—ESTABLISHMENT

Section 5171. Premises prohibited for distilling

This section is identical with section 5171 of the House bill.

The section makes two important changes in existing law (section 2819). There have also been additional clarifying changes.

The first important change is the deletion of the provision of existing law that a distillery premises could not be located within 600 feet of a premises authorized to be used for rectifying except with the specific permission of the Secretary or his delegate. The 600 feet requirement has been waived in numerous cases and is no longer believed to serve a useful purpose under modern operating conditions. Distilling and rectifying operations are presently carried on to a large part by the same proprietors. The business of rectifying and distilling can be more adequately and efficiently supervised by Government officers if the premises are reasonably contiguous. This change is in line with similar changes in other sections of this chapter.

The second major revision of this section is the granting of discretionary authority to the Secretary or his delegate to authorize businesses, other than those specifically prohibited by the statute, to be conducted on distillery premises when the Secretary or his delegate, finds that such operations will not jeopardize the revenue. There are certain types of operations in which it might be possible to utilize the facilities of a distillery without jeopardy to the revenue. One example of a type of business that might be authorized is the manufacturer of antibiotic drugs which requires large scale fermenting equipment of the same character as that used in a distillery. Certain distilleries are already engaged in this type of business and have found it necessary under present law to duplicate at great expense their fermenting facilities.

A third change is that the specific prohibition against the manufacture of ether on distillery premises has been deleted. The production of ether could be authorized on distillery premises under regulations if such operations were found not to jeopardize the revenue.

In addition to the changes referred to above there have been three changes of a clarifying nature. These clarifying changes are as follows:

(1) The words "and in any building" have been deleted from the portion of the section which prohibits distilling on any premises where beer, wines, or vinegar, etc., are manufactured since it is believed that the phraseology "on any premises" adequately covers this restriction.

(2) The reference to lager beer, ale, porter, or other fermented liquors has been deleted and the word "wine" has been added. This change more clearly states the restriction intended by the statute which is to prevent the carrying on of distilling operations on the premises where beer or wines are produced. The term "beer" is defined in section 5052 as including the enumerated types of fermented liquor which have been deleted.

(3) The last sentence of this section has been added to make it clear that the section does not prohibit the use of any still, boiler or other vessel by a rectifier, in accordance with the provisions of section 5082, in a rectifying plant qualified under this chapter.

The changes made in this section are not intended and would not have the effect of authorizing rectifying and distilling on the same premises since such joint operations would be prohibited by other provisions of law.

Section 5172. Conditions precedent to carrying on the business of distilling

This section is identical with section 5172 of the House bill.

The section makes two changes in existing law (section 2832).

The first change is the deletion of the statutory requirement that a distillery comply with the survey requirements as a condition precedent to carrying on the business of distilling. While the survey requirements have been retained, pending further study, these requirements are substantially obsolete and are now waived by regulations pursuant to the authority contained in section 5179.

The second change in this section is the deletion from existing law of the requirement that distilleries and rectifying premises be separated by 600 feet and that distilling and rectifying not be carried on within such distance. This provision has been deleted for the reasons stated in the comments with regard to section 5171.

Section 5173. Distillery fixtures and equipment

This section is identical with section 5173 of the House bill.

Subsection (a) of this section relating to fermenting and distilling equipment, etc., makes the following changes in existing law (section 2822):

(1) Existing law requires furnaces of stills and boilers used in distilleries to be so constructed that the door of the furnace may be locked. This provision has been revised to require construction of the furnace or the steam or fuel line of the still or boiler in such manner that they may be locked. The existing statute is inadequate to take care of modern equipment and has been revised for this reason.

(2) Existing law specifies in particular detail the construction of the fermenting and distilling equipment and the painting of the fixed pipelines for the conveyance of mash, beer, spirits, etc. Such detail in the statute is considered unnecessary and too restrictive and has been eliminated. The revised subsection specifies that the fermenting and distilling equipment and all fixed pipes and vessels shall be constructed, arranged and identified pursuant to regulations. The revision gives more latitude to the Secretary in prescribing the construction, arrangement, and identification of the equipment.

Subsection (b), relating to receiving cisterns, has been revised in the following respects:

Existing law (section 2820 (a)) specifies in detail the exact manner of construction of receiving cisterns. This section has been revised to maintain the statutory requirements of a closed system for the transfer of the spirits from the still to the cistern and to prohibit any abstraction of spirits between the still and the receiving cistern. However, the details of the construction, arrangement, and identification have been left to regulations, thus providing for greater flexibility in the supervision of modern operations.

The requirement that each receiving cistern be of sufficient capacity to hold 24 hours' production was deleted as unnecessarily restrictive since several receiving cisterns may be in fact required to hold a day's production. However, this revision is not intended to make any change in the present requirement that each day's production of distilled spirits be segregated.

The last paragraph of section 2820 of existing law, referring to waiver of survey requirements, was deleted as unnecessary in view of section 5552.

Subsection (c), relating to changes in apparatus and fastenings, is derived from section 2823 and is existing law.

Section 5174. Registry of stills

This section is identical with section 5174 of the House bill.

The section (derived from section 2810) constitutes a major revision of the existing law which requires all stills (with the exception of stills for refining petroleum) for whatever purpose used to be registered immediately upon being set up. The specific exemption for stills for the refining of petroleum was deleted and a proviso added in lieu thereof to the effect that stills or distilling apparatus not used or intended to be used for the distillation, redistillation, or recovery of distilled spirits are not required to be registered.

Under present law many thousands of stills used for distilling water, or in the preparation of drugs, chemicals, or for recovering cleaning fluids are required to be registered. This has placed a major burden both upon the industry using such stills and the Government. The general requirement for registration of all stills has not materially aided the enforcement of the revenue laws relating to liquors and the administrative expense and the burden upon industries using such stills is considered disproportionate to the results obtained.

The requirement for registration of stills used for the distillation, redistillation or recovery of distilled spirits has been retained since this is a fundamental enforcement aid used with regard to illicit distilling. This provision is now consistent with special tax on the manufacturers of stills, contained in section 5101, which is applicable only to stills used for distilling and is also consistent with section 5105.

Section 5175. Notice of business of distiller

This section is identical with section 5175 of the House bill.

The section (derived from section 2812) is substantially a restatement of existing law except that the details required by existing law in relation to the number and capacity of stills, boilers, mash tubs, etc., have been left to regulations, thus enabling the Secretary or his delegate to require only information that is found to be essential.

The specific requirement that notice be given in case of the change of time of fermenting has been omitted as unnecessary and the time in which a notice of change in location, form, capacity, etc., is required to be submitted to the Secretary or his delegate has been left to regulations. Existing law provides that such notice of change be submitted within 24 hours. This specific time requirement is considered unnecessary and too restrictive.

Section 5176. Distiller's bond

This section is identical with section 5176 of the House bill.

A major change in existing law (sec. 2814 (a)) has been made in this section for the purpose of giving the Government additional security in cases of payment of tax on distilled spirits by return on a deferred basis. Provision has been made that the Secretary or his delegate may require the distiller to furnish an additional bond (not limited by the $100,000 maximum) in case the distiller desires to withdraw spirits on determination of tax and make payment by return at a later date.

The additional bond would be for the purpose of securing the payment of the tax and would be in such form, and in such penal sum, as regulations prescribe. In addition, the bond would be conditioned upon compliance with such other requirements, relating to withdrawals upon determination of tax, as the Secretary or his delegate prescribes by regulations. If the tax determined on withdrawal from the distillery is not paid when due, the Government could proceed against either or both of the bonds.

Transfers in bond, or withdrawals authorized by law to be made without payment of tax, would not require the posting of the additional bond.

Section 5177. Conditions of approval of distiller's bond

This section is identical with section 5177 of the House bill and represents existing law (secs. 2815 (a) and (b) and 2814 (a) (1)).

Section 5178. Plan of distillery

This section is identical with section 5178 of the House bill.

The section has been rewritten for simplification, and has left to regulations the information regarding the equipment in the distillery which must be shown on the plan (sec. 2816).

Section 5179. Survey of distillery

This section is identical with section 5179 of the House bill and represents existing law (sec. 2817 (a) and (b)).

Section 5180. Sign required on premises

This section is identical with section 5180 of the House bill.

The section represents existing law (sec. 2831), except that the specific requirement as to the size of the sign and the requirement that the sign be painted in oil colors or gilded has been deleted and the provision inserted that the sign should be posted in the manner and form prescribed by regulations.

PART II—OPERATIONS

Section 5191. Commencement, suspension, and resumption of operations

This section is identical with section 5191 of the House bill.

The principal change in existing law (sec. 2850), made by this section is the elimination of the detail in the statute specifying the exact manner in which the Government officers lock or seal the furnaces or distilling apparatus to prevent distilling after the distiller has given notice of suspension of operations. The section provides that the Government officers shall adopt such means by locks and otherwise as the Secretary or his delegate may, by regulations, prescribe to prevent the use of the stills.

The first sentence of the section has been added for the purpose of prescribing a time when the distiller after approval of bond may commence operations. Under present administrative practice the distiller may not commence operations until a storekeeper-gauger has been assigned to the distillery to supervise the operations.

The provision has also been added that the notice required in this section shall be in such form and submitted in such manner as the Secretary or his delegate shall by regulations require.

The present statute provides that the securing of the furnace, boilers and stills shall be at the expense of the distiller. This provision has been deleted as no longer necessary.

Section 5192. Supervision of operations by storekeeper-gaugers

This section is identical with section 5192 of the House bill.

The section makes the following changes in existing law (sec. 3042):

Subsection (a) has clarified existing law to specifically require the assignment of gaugers to the distillery since the distillery cannot operate in the absence of the gaugers.

Subsection (b) gives more latitude than existing law (sec. 2820) to the Secretary or his delegate to prescribe the nature and extent of the supervision of the operation in the cistern room by the storekeeper-gauger.

Subsection (c), relating to the use of materials in the removal of spirits, is a new provision. Existing law (sec. 2838) imposes a penalty upon distillers who use materials for the purpose of making mash, wort or beer, or for the production of spirits and for the removal of distilled spirits in the absence of the storekeeper-gauger. The penalty which is contained in section 5612 has been keyed to subsection (c) and this subsection allows the Secretary or his delegate to prescribe by regulations the nature and extent of the supervision which will be required in the case of use of materials and removal of spirits.

Subsection (d), relating to storekeeper-gaugers' records is existing law (sec. 2877).

Section 5193. Drawing, gauging and marking of distilled spirits

This section is identical with section 5193 of the House bill.

The section contains the following changes in existing law:

(1) Existing law (sec. 2820) requires spirits to be drawn off on or before the end of the third day after deposit in receiving cisterns in distilleries. This restriction has been found impracticable in cases of intervening holidays or other nonworking days. Subsection (a) has therefore been revised to provide that such spirits be drawn off on or before the end of the third work-

ing day. Also, the statement that distilled spirits except as otherwise provided in section 2883 must be removed to an internal revenue bonded warehouse has been changed to "except as otherwise provided by law" since there are other provisions of law relating to the removal of distilled spirits from distilleries.

(2) The requirement of existing law (sec. 2878 (a)) that the gauging should be performed by a storekeeper-gauger has been changed to "under the supervision of the storekeeper-gauger." This change would allow the gauging to be done by the distiller under the supervision of the storekeeper-gauger. This change conforms the practice and policy of registered distilleries to the practice now carried on in alcohol plants and would make possible a more efficient use of Government personnel.

Subsections (b) and (c) are existing law (sec. 2878 (b) and (c)).

Subsection (d), which relates to gauging, marking and branding by distillers of the spirits when withdrawn from the distillery, has been changed from existing law (sec. 2878 (d)) to cover actual gauging and also to provide that such marking, branding, and gauging be under the "supervision" of the storekeeper-gauger rather than under the "immediate personal" supervision of such gauger.

Section 5194. Transfer of spirits at registered distilleries

This section corresponds to section 5194 of the House bill except that your committee has amended the fifth sentence of subsection (a) by changing "on taxpayment" to "on determination of tax." This change is necessary to conform this provision for withdrawal to the revised method of taxpayment.

The section contains the following important revisions in existing law.

In subsection (a) (derived from sec. 2883 (a)) the restriction that distilled spirits of 160° of proof or more produced at registered distilleries, including fruit distilleries, could be withdrawn for use for beverage purposes only, has been deleted. The effect of this deletion is to authorize the withdrawal of such spirits produced at registered distilleries (including registered fruit distilleries) for certain nonbeverage uses such as flavoring of foods (rum and brandy are customarily used in the flavoring of mincemeat, fruitcake, etc.) and the manufacture of flavoring extracts and medicinal preparations. Under existing law such distilled spirits produced at registered distilleries (including registered fruit distilleries) could not be withdrawn for such drawback purposes. Since rum and brandy are not produced at industrial alcohol plants, this restriction deprived nonbeverage manufacturers from obtaining such rum and brandy for their manufacturing purposes. This change is consistent with the language of existing law, which provides that distilled spirits produced in domestic registered distilleries and industrial alcohol plants may be used for the designated nonbeverage purposes with benefit of drawback.

Subsection (a) has also been revised to include tank trucks in the authorized means of transportation of distilled spirits from cistern rooms in distilleries to internal revenue bonded warehouses or from storage tanks in internal revenue bonded warehouses to other internal revenue bonded warehouses. The experience in the use of tank trucks obtained under national emergency transfer provisions (sec. 5217) has shown that this means of transportation may be used without jeopardy to the revenue.

Subsection (b), relating to the destruction or denaturation of distillates containing fusel oil or aldehydes, is existing law (sec. 2916).

Subsection (c), relating to transfer of rum for denaturation, is existing law (sec. 2883 (c)).

Under existing law wine spirits of 160° of proof or more may be transported in tank cars from cistern rooms of distilleries to internal revenue bonded warehouse, but transportation of such spirits by tank trucks is not permitted. Subsection (d) as revised would permit such transportation.

Paragraph (1) of subsection (e) represents existing law (sec. 2883 (d)) except that the statement "upon payment of tax" has been changed to "upon determination of tax". This change was necessary to conform this provision to the revised method of taxpayment.

Paragraph (2) of subsection (e) is a new provision authorizing vodka and gin of any proof to be transferred in bond in tank cars and tank trucks from distilleries to internal revenue bonded warehouses, and the removal therefrom, upon determination of tax, in tank cars and tank trucks. Existing law precludes gin of less than 160° of proof and vodka from being transported in tank cars and tank trucks. This is a liberalizing change to facilitate the transportation of such spirits under modern operating conditions.

Subsection (f) has been substantially revised from existing law (sec. 2883 (e)) to provide more latitude in the methods of transfer and the types of containers authorized to be used for transporting spirits for redistillation. Existing law restricts such removals by pipelines to transfers from storage tanks in internal revenue bonded warehouses and receiving tanks in distilleries to contiguous distilleries. This subsection eliminates the restriction in existing law that the proof of the spirits transferred by pipeline be 160° or more and also permits the transfer of spirits from any tank in the internal revenue bonded warehouse. This subsection would permit the transfer of spirits in any approved container for redistillation. These changes are of a liberalizing character and are deemed to be desirable to facilitate modern improved operations. Existing law also contains a restriction that there must be a showing of need for redistillation. This requirement has been eliminated as unnecessary and unduly restrictive of the distiller's operations.

Subsection (g), empowering the Secretary or his delegate to prescribe regulations, is existing law (sec. 2883 (f)).

Subsection (h) is existing law (sec. 2883 (g)).

Section 5195. Restrictions relating to operations

This section is identical with section 5195 of the House bill and represents existing law.

Section 5196. Entry and examination of premises

This section corresponds to section 5196 of the House bill and is the same as that section except that subsection (a) has been amended by deleting the term "government officers" and substituting in lieu thereof the term "internal revenue officers". This change has been made in the interest of uniformity of language. Numerous other provisions of chapter 51 make provision for supervision or inspection by internal revenue officers. The term "government officers" in this section was intended to refer to "internal revenue officers" and the foregoing change has been made in order that the language of the various provisions will be consistent.

There have been combined into this section the five sections of existing law relating to entry and examination of distillery premises. (See secs. 2826, 2827, 2828, 2830, and 2839.)

The existing law contains a limitation on the walls or fences which can be erected on distillery premises and limits such fences or walls to 5 feet in height, except upon specific permission from the Secretary or his delegate. In a very large percentage of the cases this requirement has been waived. This limitation on the height of fences and walls is not considered to serve any useful purpose. At the time the restriction on the height of fences was inserted in the statutes the distillers were not required to furnish keys to the premises. Since Government officers now have keys to the premises, the fence restriction is no longer necessary nor desirable in view of the fact that higher fences or walls are needed to protect the premises against trespassers, and this restriction in existing law has been deleted from subsection (a). In addition, subsection (a) has been changed to make it clear that the distiller must furnish the Secretary or his delegate such keys to the Secretary or his delegate as may be required by Government officers to gain access to the distillery premises and structures. The present law merely provides for keys to the gates and doors of the distillery, while under this subsection as revised, the Secretary could require the furnishing of keys to any structure on the premises. (Sec. 2826.)

Subsection (b), relating to the right of entry and examination of distilleries, is existing law. (Sec. 2827.)

Subsection (c), relating to the furnishing of facilities and the giving of assistance to revenue officers in examining distillery premises, is existing law. (Sec. 2828.)

Subsection (d), relating to authority to break up grounds or walls, is existing law. (Sec. 2830.)

Subsection (e), relating to examination of worm tubs or condensers in distilleries, is existing law. (Sec. 2839.)

Section 5197. Distiller's records and returns

This section corresponds to section 5197 of the House bill and is the same as that section except that section 5197 (a) (1) (B) has been amended by deleting the term "any government officer" and substituting in lieu thereof the term "any internal revenue officer". This change has been made in the interest of uniformity of language. Numerous other provisions of chapter 51 make provision for supervision or inspection by internal revenue officers. The term "any government officer" in this section was intended to refer to "any internal revenue officer" and the foregoing change has been made in order that the language of the various provisions will be consistent.

Into this section have been incorporated the various provisions of law relating to the records and returns of distillers (secs. 2841, 2859, and 2844). Existing law providing for the special return of the number of barrels distilled has been deleted as unnecessary since such information may be obtained under the provisions of this section.

Subsection (a) (1) relates to the keeping of records by the distiller of his operations. The specific requirement that the records show the name of the person to whom the spirits were sold was deleted from this paragraph since such information is more appropriately required under the provisions of subsection (a) (2). The provision that the distiller record the kind of spirits produced and removed has been added since this information is necessary for statistical purposes and to assure adequate records of the identity of the products distilled. The specific provision of existing law that a record of the "proof" of the spirits be recorded has been deleted. However, under this subsection the Secretary may, by regulations, require that additional particulars be stated in the records.

Paragraph (2) of subsection (a), relating to the records of wholesale liquor dealers, requires the distiller to keep records of distilled spirits of his own production disposed of by him, in a manner similar to the records required of wholesale liquor dealers under the provisions of section 5114. The time required for the keeping of such records in existing law has been reduced from 4 years to 2 years to conform with the provisions of section 5114 and to correspond with the period required for the keeping of distillers' basic records.

The existing law relating to the monthly return of distillers (sec. 2844) contains lengthy detail of the information to be contained on the return and the form of oath under which the return must be subscribed. Subsection (b) as revised has eliminated the specific oath and the detail and provides that the distiller shall submit a monthly return of operations of the preceding month, taken from his records, in such form and manner and containing such information as the Secretary or his delegate may, by regulations, require. The revised subsection will enable the Secretary or his delegate to determine the information to be submitted on the return.

Part III—General Provisions Relating to Distilleries and Distilled Spirits

Section 5211. Detention of casks, packages or containers on suspicion

This section corresponds to section 5211 of the House bill. Your committee has amended this section to insert the words "determined as required by law, or", after the words "paid or" where they appear in the fourth line of this section as passed by the House. This amendment is required by the change in the method of taxpaying distilled spirits. As section 5211 was worded in the House bill, an internal revenue officer was authorized to detain any package upon which he had reason to believe the taxes imposed by law had not been paid. Inasmuch as under the return system adopted in this bill many casks or packages will be removed before they are taxpaid, it is felt that it is necessary to include the term "determined" in order to protect spirits legally removed.

The section is existing law (sec. 2804), except that in addition to casks and packages it has been made applicable to other containers. The internal revenue laws from time to time have been amended to permit the packaging of distilled spirits in containers other than casks or packages, and it is important that the detention of such containers be authorized in the same manner as casks or packages.

Section 5212. Prevention and detection of fraud

This section is identical with section 5212 of the House bill.

The section is existing law (sec. 2808), except that the reference to fraud by "distillers of spirits" has been deleted. The reason for the deletion is that the fraud may be committed by persons other than distillers, such as warehousemen, etc.

Section 5213. Return of materials used in the manufacture of distilled spirits

This section corresponds to section 5213 of the House bill, and except for a technical correction, is the same as that section. Your committee has deleted the word "be" in the fourth line of subsection (a) preceding the word "regulations" and has substituted therefor the word "by".

The section is substantially a restatement of existing law (sec. 2811). The definition of "person" contained in existing law has been deleted as unnecessary in view of the general definition of this term in the code. The definition of distilled spirits has been restated for the purpose of clarity, but has not been changed in substance.

Section 5214. Regulation of traffic in containers of distilled spirits

This section is identical with section 5214 of the House bill.

The section is existing law (sec. 2871), with the following exceptions:

(1) The parenthetical qualification "of a capacity of less than 5 wine gallons" has been changed to "of a capacity of not more than 5 wine gallons" and the words "at retail" have been deleted. The effect of this change is to authorize the regulation of traffic in containers of 5-gallon capacity or less, which are customarily used for the packaging and transportation of untaxpaid distilled spirits.

(2) The definition of distilled spirits in subsection (a) (1) has been restated for the purpose of clarification but there has been no change in substance.

Section 5215. Exemption of distillers of fruit brandy from certain requirements

This section corresponds to section 5215 of the House bill and, except for a technical correction, is the same as that section. Your committee has deleted the word "spirit" on the seventh line of the section from the statement "to such brandy or wine spirit spirits."

The section has been substantially revised from existing law to eliminate detailed references to the kinds of fruits to which existing law is applicable. The detailed recitation of fruits necessitated the frequent amendment of this section. The section as revised extends the exemption to brandy or wine spirits produced exclusively from fresh or dried fruits or their residues, or the wine or wine residues therefrom, or any persons responsible therefor. In existing law (sec. 2825) the exemption was applicable only to distillers of the enumerated fruits.

The section also makes provision for any scientific university, college of learning, or institution of scientific research to produce, receive, blend, treat, and store brandy or wine spirits without payment of tax for experimental or research use as authorized by regulation on the filing of a bond. This is a new provision to facilitate research.

The provisions of existing law relating to the use of sweetened grape cheese for distillation has been deleted and the provision has been added that natural wines to which sugar or sweetening has been added may be used as distilling material if the unfermented sugars are not refermented. These changes would prohibit the use of added sugar as a distilling material in fruit distilleries in the production of brandy or wine spirits.

Section 5216. Mash, wort and vinegar; vinegar factories

This section corresponds to section 5216 of the House bill. Your committee has amended subsection (a) by inserting after paragraph (3), paragraph (4) which providés authority for the Secretary or his delegate to authorize by regulations removal of mash, wort or wash from the distillery prior to distillation, if made and fermented in carrying on a business (other than distilling) authorized by regulations prescribed under section 5171 (a). Section 5171 (a) of this bill amends existing law to provide that the Secretary or his delegate may by regulations authorize such other businesses to be carried on by a distiller on the distillery premises as the Secretary finds will not jeopardize the revenue. One of the other businesses contemplated by the provisions of section 5171 is the production of antibiotic drugs which require fermentation. The antibiotic drugs would be removed after fermentation from the distillery premises for further processing and the amendment of section 5216 (a) made above is necessary in order that such removal may be authorized.

The section makes the following changes in existing law (sec. 2834):

(1) The requirement of existing law that a vinegar factory be located 600 feet or more from a distillery or rectifying plant has been deleted. This change is consistent with the deletion of a similar restriction as to the location of distilleries in relation to rectifying plants.

(2) The existing law prohibited the use of spirits or alcohol in manufacturing any article unless the spirits or alcohol were produced in an authorized distillery and (except in the case of vinegar) the tax thereon paid. In order to cover the conditions created by the change in the method of taxpayment from payment by stamp to payment by return, this was changed to require that the tax be paid in such cases or "determined as provided by law." This is consistent with similar changes in connection with other sections relating to the taxpayment of spirits.

The reference to exemptions in the case of certain vinegar factories was deleted since no such plants are now operating, and such exemption provisions have been deleted as obsolete.

Section 5217. Exemptions relating to national emergency transfers

This section is identical with section 5217 of the House bill and represents no material change in existing law.

SUBCHAPTER C—INTERNAL REVENUE BONDED WAREHOUSES

Part I—Establishment

Section 5231. Authority to establish

This section is identical with section 5231 of the House bill.

The section contains provisions of existing law (secs. 2872, 2873, and 2875) relating to the establishment of internal revenue bonded warehouses. Existing law provides for only one type of warehouse for the storage of spirits produced at a registered distillery; therefore, language relating to distinctions between types of warehouses for the storage of distilled spirits produced at registered distilleries has been eliminated as obsolete.

The words "including a registered fruit distillery" were added to the end of the first sentence of this section for the purpose of clarification. This does not represent a substantive change in the law.

Section 5232. Bond requirements

This section corresponds to section 5232 of the House bill. Your committee has revised the last sentence of subsection (a) to clarify the language which if not amended might be construed as requiring distilled spirits to be taxpaid within 8 years and thereby preclude payment by return on spirits reaching the 8 year limit. The amendment clearly requires distilled spirits to be withdrawn from internal revenue bonded warehouses within 8 years from the date of original entry, but the tax determined upon withdrawal from bond could be paid by return at the time prescribed for filing such return. The bond would be conditioned on such payment of the tax.

The section represents a major change in existing law (sec. 2879). Due to the change in the method of tax payment of distilled spirits, from payment by stamp to payment by return, it was deemed necessary to provide additional security to protect the revenue.

Under existing law the maximum bond for an internal revenue bonded warehouse is $200,000 and such bond is conditioned upon the payment of the tax at the time of withdrawal of the spirits from the warehouse and within 8 years from the date of the original entry of the spirits into an internal revenue bonded warehouse. Under the system of payment of the tax by stamp, as provided by existing law, the tax is paid on the spirits before they are removed from the warehouse. Under the system of payment of the tax by return the tax may be determined upon withdrawal of the spirits from the warehouse and the tax paid by return at some later date as specified by regulations. Therefore, the warehouseman's bond as now drawn under existing law would offer no protection to the revenue in cases where the tax was determined upon withdrawal but was not actually paid by return when due. In order to correct this situation the basic warehouseman's bond (with a maximum of $200,000) has been conditioned on the payment of the tax on the spirits as determined upon withdrawal of the spirits from the internal revenue bonded warehouse on withdrawal of the spirits within 8 years from the date of original entry and upon compliance with all provisions of law and regulations relating to the warehousing of distilled spirits.

As a further protection to the revenue an additional bond has been provided for in all cases (except withdrawals without payment of tax or transfers in bond) where the tax is not paid at the time of withdrawal. No maximum limit has been placed upon this additional bond. In cases of warehousemen deferring payment, such warehousemen would post both bonds. If the tax determined upon withdrawal was not paid when due, the Government could proceed against either or both of the bonds. The form and penal sum of the additional bond will be prescribed by regulations.

Section 5233. Establishment of bottling-in-bond department

This section is identical with section 5233 of the House bill and is a cross-reference section only.

Part II—Operation

Section 5241. Supervision of operations

This section is identical with section 5241 of the House bill.

The section combines the provisions of various sections of existing law, insofar as they relate to the supervision of operations of internal revenue bonded warehouses. (Secs. 2872, 2873, 2915, 4013.)

Subsection (a), relating to maintenance and supervision of internal revenue bonded warehouses, is existing law.

Subsection (b), relating to the assignment of gaugers to internal revenue bonded warehouses, is substantially a restatement of existing law. However, the requirement that gaugers be assigned to "every" internal revenue bonded warehouse has been deleted since in some cases it is only necessary to have gaugers at warehouses when spirits are entered or withdrawn and such entries or withdrawals are made on an intermittent basis. With this change it will be possible for one storekeeper-gauger to supervise operations at more than one warehouse as the need arises.

Subsection (c), relating to the records and returns to be kept and submitted by storekeeper-gaugers, provides for the keeping of the basic records of deposits and removals of spirits in internal revenue bonded warehouses, and the statutory requirement for the keeping of such records has been retained. However, statutory detail contained in existing law has been eliminated and left to regulations. Also, the detailed requirements relating to the submitting of reports by the storekeeper-gauger have been deleted and the provision included that the storekeeper-gauger will submit such reports and in such form and manner and at such time as the Secretary or his delegate may require.

Section 5242. Deposit of spirits in warehouses

This section corresponds to section 5242 of the House bill and is the same as that section except that your committee has amended section (b) (5) by deleting the letter (b) following the reference to section 5006 and substituting in lieu thereof the letter "(a)". This is a typographical correction only.

Section 5243. Bottling of distilled spirits in bond

This section is identical with section 5243 of the House bill.

There has been incorporated in this section the various provisions of existing law relating to the bottling of distilled spirits in bond. The section, with the limited exceptions noted below, is a restatement of existing law.

The provisions of existing law (sec. 2903), relating to bottled in bond strip stamps, are contained in section 5008 (a).

Subsection (a) is existing law (secs. 2903, 2904).

Subsection (b), relating to bottling requirements, represents existing law (secs. 2904–2910), with the following exceptions:

(1) The requirement of existing law that the bottling be in the presence of the storekeeper-gauger has been changed to require that such bottling be under the "supervision" of the storekeeper-gauger.

(2) The existing law states that the "distiller" may bottle in bond. This has been changed to "warehouseman" may bottle in bond. The reference to "distiller" is obsolete since the bottling is actually performed by the proprietor of the internal revenue

bonded warehouse. Under provisions of existing law there is only one class of warehouse, which is an internal revenue bonded warehouse.

(3) The existing law limitation in the last sentence of subsection (b) that gin bottled in bond for export must be bottled at a distillery, has been deleted as an obsolete restriction. The bottling of spirits in bond is presently carried on exclusively in an internal revenue bonded warehouse. (Sec. 2910.)

Subsection (c), relating to trade-marks on bottles, is existing law. See sec. 2903 (g).

Subsection (d) is existing law, with the exception that the reference to "whisky" has been changed to "distilled spirits," since this requirement is construed as applicable to all distilled spirits bottled in bond. See sec. 2903 (f).

Subsection (e), which relates to exportation of spirits bottled in bond, is existing law. See sec. 2905.

Subsection (f), which relates to the effect of this section upon State laws, is existing law. See sec. 2911.

Section 5244. Withdrawal of spirits upon determination of tax

This section is identical with section 5244 of the House bill.

A modification of the provisions of existing law (sec. 2882) has been made to conform to the change in the method of taxpayment of distilled spirits. Section 5006 provides that the tax shall be determined at the time the spirits are removed from bond, and section 5061 provides that the tax on distilled spirits shall be paid by return (unless otherwise provided by regulation). It is contemplated that a return may cover a specific lot of spirits being taxpaid or may cover a number of lots of spirits removed at intervals throughout a day, week, or month. Accordingly, removals of spirits cannot be conditioned upon taxpayment at the time of removal. This section therefore provides that distilled spirits may, upon determination of the tax, be withdrawn from the warehouse. Further change has been made by eliminating details on the application for withdrawal now prescribed by existing law and authorizing the Secretary or his delegate to prescribe by regulation the form of the application and the details to be shown thereon.

Section 5245. Withdrawal of spirits on original gauge

This section is identical with section 5245 of the House bill.

Existing law (sec. 2881) has been modified to permit any package, whether it is a package of distilled spirits withdrawn from receiving cisterns, or a package filled from warehouse storage tanks, to be removed on the original gauge. Further modification was made by eliminating the 30-day storage period during which spirits could be removed on the original gauge. Under the revised language, the spirits could be removed on the original gauge at any time during the period of storage. This liberalization of the law is not expected to result in any loss of revenue and to the extent used will eliminate regauging.

Section 5246. Transfers of spirits in bond

This section is identical with section 5246 of the House bill.

Existing law (sec. 2875) authorizes the transfer of distilled spirits between internal revenue bonded warehouses. Under this section, transfers of spirits in bond between internal revenue bonded warehouses may be made in original packages, as authorized by existing law, or in other packages or containers as prescribed by regulations.

Section 5247. Withdrawal of spirits for exportation

This section corresponds to section 5247 of the House bill. Your committee has amended subsection (b) by deleting the words "the name of" preceding the words "the collector of the port to whom the spirits are to be consigned". It is often inconvenient for the exporter to ascertain the name of the collector of the port to whom the spirits are to be consigned and such information is not considered necessary.

The report of the House Ways and Means Committee states that the change made above has been made. However, the text of the section as passed by the House still contains the deleted words. The change made by your committee conforms the language of the bill to the statement in the House report. Your committee has amended subsection (b) by deleting the word "ship" preceding the language "at a port of exportation to be made therein" and inserting in lieu thereof the words "an export carrier". This change is considered desirable since the distilled spirits may in fact be delivered on board an export carrier other than a ship, such as a rail or motor carrier.

Existing law (sec. 2885 (a)) has been revised to eliminate excessive statutory detail and to leave to regulations the determination of the evidence indicating exportation which will be required. Existing law requires evidence of landing at the foreign port. Export procedures under this section could now by regulation be made to conform to procedures for exportation with benefit of drawback under section 5062 (b).

Subsection (a) contains the following changes in existing law:

(1) Specific provision has been made for packages filled from original casks or packages. This change is consistent with the last sentence in subsection (c).

(2) Provision is made in the last sentence of subsection (a) that the bonds given under this section may be canceled or credited upon the submission of such evidence, records, and certificates, indicating exportation as the Secretary or his delegate shall by regulations prescribe. Existing law requires proof of landing at the foreign port or proof of loss at sea for cancellation of export bonds.

Subsection (b) is substantially a restatement of existing law (sec. 2885 (b)). However, the requirement for statement of the name of the collector of the port to whom the spirits are to be consigned has been omitted as unnecessary.

Subsection (c) modifies existing law in the following respects:

(1) Existing law (sec. 2886) requires the gauge of the spirits prior to exportation by the customs gauger. Under this subsection the quantity of spirits entered for exportation will be required to be determined by inspection or gauge as regulations shall prescribe. This would permit the acceptance of the internal revenue gauge where no jeopardy to the revenue would appear to be involved.

(2) Existing law requires a transportation bond covering transportation of the spirits to the port of exportation and an export bond covering the exportation of the spirits. Under this subsection, the giving of the additional export bond would

be discretionary with the Secretary depending upon the evidence of exportation which he requires.

(3) Existing law specifies the manner of cancellation of the export bond and provides that it shall be canceled upon proof of landing at the foreign port or of loss at sea. This provision had been deleted and the cancellation of such bond would be under the provisions of subsection (a).

(4) Existing law permits the withdrawal of spirits from bond in "new" packages after recasking. The phraseology "in such packages as the warehouseman desires to export" has been substituted for the word "new". This change was made for the purpose of eliminating the inference that the exporting package must be an unused container.

Subsection (d) has been changed from existing law (sec. 2888) to eliminate the requirement that the distilled spirits or alcohol to be exported in tank cars must be of not less than 180 degrees of proof. The restriction on the proof of exportation in such containers has been deleted. This means that tank cars could be filled under the provisions of section 5194 (a) with spirits of 160 degrees or more of proof and be exported under subsection (d) of this section.

Subsection (e), relating to losses, has been added for the purpose of clarifying the application of the provisions of section 5011 (a). All losses of distilled spirits while in bond (except losses of alcohol covered by sec. 5011 (c)) are covered by 5011 (a). This subsection makes no substantive change in existing law.

Section 5248. Withdrawal of spirits without payment of tax

This section is identical with section 5248 of the House bill and is a cross reference section only.

Section 5249. Prohibited hours for removal of spirits

This section corresponds to section 5249 of the House bill. Your committee has made a correction of a typographical error by changing the reference "see section 5195 (d) (1)" to read "see section 5195 (b)".

Section 5250. Gauging, stamping and branding of spirits removed from warehouses

This section is identical with section 5250 of the House bill.

The section contains the following changes in existing law (sec. 2884):

(1) The statement that the spirits upon which the tax had been paid were to be gauged has been revised to make it clear that the gauging precedes the determination or payment of the tax.

(2) The provisions of existing law relating to the marking and branding of the spirits by the proprietor under the immediate personal supervision of the storekeeper-gauger has been modified to state that such marking and branding shall be under the "supervision" of the storekeeper-gauger.

(3) A provision has been added to existing law to the effect that the storekeeper-gauger shall determine the tax on the spirits at the time they are gauged for removal for taxpayment. This change is consistent with changes in other provisions which require that tax be determined upon withdrawal of the spirits from the warehouse.

Section 5251. Blending of beverage brandies in internal revenue bonded warehouses

This section is identical with section 5251 of the House bill and refers to section 5023 for provision relating to the blending of beverage brandies in internal revenue bonded warehouses.

Section 5252. Discontinuance of warehouse and transfer of merchandise

This section is identical with section 5252 of the House bill and represents existing law. See section 2874.

SUBCHAPTER D—RECTIFYING PLANTS

Part I—Establishment

Section 5271. Notice of business of rectifier

This section is identical with section 5271 of the House bill.

The following substantive changes in existing law (sec. 2812) have been made in this section

(1) The provision requiring the rectifier's notice to contain the statement that the premises were not to be located within 600 feet of premises authorized for distilling has been deleted. This change is consistent with similar changes in other sections which have deleted the 600-feet requirement.

(2) The basic information required by existing law to be stated in the rectifier's notice has been retained. However, the excessive detail has been omitted from the statute and provision made that in addition to the specific information required in the statute, the Secretary or his delegate may, by regulations, require additional particulars.

(3) Under existing law notices of change were required to be given to the Secretary or his delegate within 24 hours. The time of filing such notices of change has been left to regulations.

Section 5272. Bond

This section is identical with section 5272 of the House bill.

The section is in substance a restatement of existing law. (See section 2801 (e) (1).) It was not found necessary to revise this section due to the changeover of the method of taxpayment in order to increase the Government's security, since under existing law the penal sum of the bond and the conditions thereof are left to regulations.

Section 5273. Premises

This section is identical with section 5273 of the House bill and represents existing law. See section 2801 (e) (2).

Section 5274. Sign required on premises

This section is identical with section 5274 of the House bill.

The section is substantially a restatement of existing law. See section 2831. However, the requirement of existing law that the sign be in gilt or oil colors of a specific size has been omitted and the provision inserted that the sign should be posted in the manner and form prescribed by regulations.

Section 5275. Cross references

This section is identical with section 5275 of the House bill and contains cross references to other provisions of law imposing requirements upon rectifiers.

Part II—Operation

Section 5281. Regulation of business of rectifier

This section corresponds to section 5281 of the House bill and represents existing law (sec. 2801 (d) and (e)) with the exception that your committee has revised the last sentence of subsection (a) for the purpose of clarification. Under the provisions of the Federal Alcohol Administration Act (49 Stat. 977; 27 U. S. C. 205 (e)), bottlers of distilled spirits, such as blended whisky, which contain neutral spirits, are required to show the name of the commodity from which the neutral spirits were distilled.

The last sentence of section 5281 (a) as it appeared in the House bill could have been construed as being in conflict with the Federal Alcohol Administration Act.

Since there is no intent that section 5281 (a) should in any manner supersede or modify the labeling requirements of the Federal Alcohol Administration Act your committee deemed it desirable to clarify the language of subsection (a).

Your committee also made a change in paragraph (1) of subsection (b) by striking out "5272 (a)" and inserting, in lieu thereof, "5273 (a)." This is a typographical correction.

Section. 5282. Rectification of spirits

This section is identical with section 5282 of the House bill.

The section combines provisions of existing law relating to notice of intention to rectify, gauging, and affixing of stamps to certain rectified products.

Subsection (a), relating to notice of intention to rectify, in substance represents existing law (sec. 2813), except that the requirement relating to the gauging prior to rectification has been omitted since this requirement is covered under subsection (b).

Subsection (b), relating to gauging, branding, and stamping of rectified spirits, represents existing law (sec. 2861), except that certain statutory detail relating to the information required to appear on the stamp has been left to regulations.

Subsection (c), relating to the affixing of stamps, is a restatement of existing law (sec. 2862), except that the statutory requirement for filling in all the blanks on the stamp has been deleted as unnecessary.

Section 5283. Examination of premises

This section is identical with section 5283 of the House bill.

The section makes applicable the provisions of section 5196 (c) and (d), which require the giving of assistance to revenue officers for examination of the premises and authorize revenue officers to break up grounds or walls. This section represents, in substance, existing law. See sections 2828 and 2830.

Section 5284. Prohibited hours for removal of distilled spirits

This section is identical with section 5284 of the House bill and is a cross reference section only.

Section 5285. Records and returns

This section is identical with section 5285 of the House bill.

The section combines the provisions of existing law relating to rectifiers' monthly returns and records of rectifiers as wholesale dealers.

Subsection (a), relating to monthly returns, is a simplification of existing law. See section 2855. The specific detail, including the requirement of furnishing a copy of the return to the Commissioner, has been eliminated. Under this subsection the rectifier is required to file a monthly return of operations of the preceding month, taken from his records, in such form and manner and containing such information as the Secretary or his delegate may, by regulations, prescribe. The information required on the return will be taken from the records of the rectifier. The keeping of records necessary to make the return could be required.

Subsection (b), relating to the records of rectifiers or rectifiers as wholesale dealers (section 2857 of existing law), has been revised in a manner similar to the revision of section 5114, which describes the records of wholesale liquor dealers. Under existing law the rectifier is classed as a wholesale liquor dealer and is required by statute to file summaries and transcripts. Under this subsection, transcripts, summaries, and copies of records would be rendered only as required by regulations.

The requirement of existing law that the records prescribed by subsection (b) be kept for a period of 4 years, has been changed to 2 years in conformity with similar changes in other sections. Under existing law these records are required to be kept at the rectifier's place of business covered by the special tax stamp. This requirement has been deleted since it has been found practical in some instances to permit the records to be kept at the principal office of the rectifier.

SUBCHAPTER E—INDUSTRIAL ALCOHOL PLANTS, BONDED WAREHOUSES, DENATURING PLANTS, AND DENATURATION

PART I—INDUSTRIAL ALCOHOL PLANTS, BONDED WAREHOUSES, AND DENATURING PLANTS

Section 5301. Establishment of industrial alcohol plants

This section is identical with section 5301 of the House bill and represents existing law. See section 3100.

Section 5302. Establishment of industrial alcohol bonded warehouses

This section is identical with section 5302 of the House bill and represents existing law. See section 3101.

Section 5303. Establishment of industrial alcohol denaturing plants

This section is identical with section 5303 of the House bill and represents existing law. See section 3102.

Section 5304. Alcohol permits

This section is identical with section 5304 of the House bill.

The section is existing law. See section 3114.

The conditioning of permits upon compliance with "this part" has been changed to compliance with "this chapter" since certain provisions formerly appearing in this part now appear elsewhere in the chapter.

The reenactment of the last sentence of subsection (b), which states that during the pendency of appeal from administrative revocation of a permit, such permit shall be revoked, is not intended to deprive permittees of any rights which may have been derived from the Administrative Procedure Act.

Section 5305. Regulations for establishing, bonding, and operation of plants and warehouses

This section is identical with section 5305 of the House bill and represents existing law. See section 3105.

Section 5306. Exemption of industrial alcohol plants and warehouses from certain laws

This section is identical with section 5306 of the House bill.

Existing law (sec. 3103) exempts industrial alcohol plants and bonded warehouses established under the provisions of this part from certain specified sections of the Revised Statutes as they existed on October 28, 1919 (the date of enactment of title III of the National Prohibition Act).

In view of the amendment of the various sections of the Revised Statutes cited in existing law, and of the combination and rearrangement of these sections, it is impossible to reenact existing law in its exact form. However, the exemptions from rectification tax (by virtue of exemption from sec. 5082) and from the special taxes imposed by part II of subchapter A have been continued, and insofar as practicable the Revised Statutes referred to have been appropriately converted.

Since, under the terms of this section, it is possible to exempt by regulations from "other provisions of law relating to distilleries and bonded warehouses" or to embody in regulations any provisions of the sections enumerated, the intent of this section has not been changed.

Section 5307. Production, use, or sale of alcohol

This section is identical with section 5307 of the House bill.

The section is existing law (sec. 3106) except that the phrase "as in this part provided" was dropped from the end of this section. The provisions relating to the taxpayment of alcohol which formerly appeared in this part are now contained in subchapter A and it was therefore necessary to delete the above referred to limitation.

Section 5308. Transfer of alcohol to other plants or warehouses

This section is identical with section 5308 of the House bill and represents existing law. See section 3107.

Section 5309. Withdrawal of fermented liquors to industrial alcohol plants

This section is identical with section 5309 of the House bill and represents existing law. See section 3104.

Section 5310. Withdrawal of alcohol free of tax

This section is identical with section 5310 of the House bill and represents existing law.

Section 5311. Importation of alcohol for industrial purposes

This section is identical with section 5311 of the House bill and represents existing law. See section 3125 (a).

Section 5312. Remission or refund of tax on alcohol for loss or leakage

This section is identical with section 5312 of the House bill and is a cross-reference section only.

Section 5313. Powers and duties of persons enforcing this part

This section is identical with section 5313 of the House bill.

Subsection (a) is existing law. See section 3121 (a).

The provisions of existing law relating to the delegation of duties to assistants have been deleted as unnecessary in view of the reorganization plans which gave such authority to the Secretary.

Subsection (b), relating to the power to secure records, is existing law.

Section 5314. Officers and agents authorized to investigate, issue search warrants, and prosecute for violations

This section is identical with section 5314 of the House bill.

The section is existing law. See section 3117. The references to title 18 of the United States Code have been changed to conform to the new sections of revised title 18.

The reference to section 7302 has been inserted in this section since it is derived from provisions formerly contained in "this part". The authority under this section with regard to seizures under section 7302 has been preserved.

Section 5315. Compliance with court subpena as to testifying or producing records

This section is identical with section 5315 of the House bill.

The section is existing law. See section 3119.

The reference to section 5686 was inserted since the provisions thereof are derived from a section formerly contained in "this part".

Section 5316. Form of affidavit, information, or indictment

This section is identical with section 5316 of the House bill.

The section is existing law. See section 3120. The reference to section 5686 was inserted since the provisions thereof are derived from a section which formerly appeared in "this part".

Section 5317. Applicability of other laws

This section is identical with section 5317 of the House bill.

Subsection (a), relating to the applicability of internal revenue laws to this part, is existing law. See section 3122. The reference to section 5686 is inserted since it is derived from a section which appeared in "this part".

Subsection (b) is existing law. See section 3121 (d).

Section 5318. Application of part to Puerto Rico and Virgin Islands

This section is identical with section 5318 of the House bill.

The section is existing law. See section 3123. The reference to section 5686 is added since this section is derived from a section which formerly appeared in "this part".

Section 5319. Definitions, etc.

This section is identical with section 5319 of the House bill.

The section is substantially existing law. See section 3124. The preface at the beginning of the section has been revised to include reference to section 5686, which is the penalty section applicable to "this part".

Paragraphs (1), (2), (3), (4), (6), and (8) are existing law.

In paragraph (5), which defines the term "bond," reference has been made to bonds issued under part II of subchapter C of chapter 26 of the Internal Revenue Code of 1939, as amended. The purpose of including the reference to the 1939 Code is to make applicable the provisions of this part to bonds issued under prior law and regulations and to make it clear that the enactment of this part will not require the supplanting of existing bonds with new bonds.

Paragraph (7) has been revised to include appropriate reference to section 500 (a) (6). This addition does not represent a change in existing law since section 500 (a) (6) was formerly contained in "the part."

Paragraph (8) is existing law.

Section 5320. Cross references

This section is identical with section 5320 of the House bill and contains references to other provisions of law relating to industrial alcohol.

PART II—DENATURATION

Section 5331. Withdrawal from bond tax free

This section is identical with section 5331 of the House bill and corresponds to section 3070 of the Internal Revenue Code of 1939.

In reenacting these provisions your committee recognizes that denatured alcohol has long been authorized for use in external liquid medicinal preparations (including mouthwashes, gargles, nose drops, and similar preparations) and it is not intended that this practice be affected.

Denatured alcohol was first provided for in 1906. Other laws dealing with denatured alcohol have been enacted since that time. The latest enactment on that subject was title III of the National Prohibition Act.

In the Internal Revenue Code of 1939 which was a codification of all internal revenue laws, the denatured-alcohol provisions of the Act of 1906 were incorporated as sections 3070 (a) and 3072 and the provisions of the National Prohibition Act in that regard were incorporated as sections 3100-3116.

This proposed revised Internal Revenue Code as was stated by the Ways and Means Committee is not a complete revision as to the distilled spirits provisions. A task force of the Internal Revenue Service is working with industry and further revision of the distilled spirit provisions is to be reported for consideration at the next session of Congress.

There is now pending in the courts litigation involving the construction and interpretation of said sections 3070 (a), 3072, 3102, and 3108 (a) of the 1939 Code. Pending further consideration in the next Congress, said sections are reported for reenactment in this code as sections 5331 (a), 5647, 5303, and 5310 (a). However, such reenactment should not be considered in any way in the pending litigation as to the meaning or interpretation to be given to existing law.

Section 5332. Recovery of spirits for reuse in manufacturing

This section is identical with section 5332 of the House bill, except that the headnote has been amended by changing "Manufacture" to "Manufacturing." This is a typographical correction.

The section is existing law with regard to alcohol. See section 3073. However, authorization for the recovery of rum has been added since it is believed that manufacturers using denatured rum should have the same right to recovery extended to manufacturers using denatured alcohol.

Section 5333. Sale of abandoned spirits for denaturation without collection of tax

This section is identical with section 5333 of the House bill and represents existing law. See section 3074.

Section 5334. Cross references

This section is identical with section 5334 of the House bill and contains references to other provisions of law relating to denatured alcohol.

SUBCHAPTER F—BONDED AND TAXPAID WINE PREMISES

PART I—ESTABLISHMENT

Section 5351. Bonded wine cellar

This section is identical with section 5351 of the House bill.

The section changes existing law (secs. 3031, 3040) in that premises presently identified as bonded wineries and bonded wine storerooms will be identified as "bonded wine cellars." Administrative difficulties have been experienced in determining whether some premises should be identified as "bonded wineries" or as "bonded storerooms." This section makes no distinction between premises on which untaxpaid wines are stored or produced, except that a bonded wine cellar definitely engaged in the production of wine, upon application of the proprietor and in the discretion of the Secretary or his delegate, may be designated as "bonded winery."

Section 5352. Taxpaid wine bottling house

This section is identical with section 5352 of the House bill.

Under existing law the Government cannot supervise the bottling of taxpaid wines or require that such bottlers maintain records revealing the nature and extent of their operations. The lack of such control has led to administrative difficulties as well as frauds on the revenue and the consumer. This section will enable the Government to have consistent requirements regarding the bottling of wines regardless of whether the wines are bottled on bonded premises or after taxpayment.

Section 5353. Bonded wine warehouse

This section is identical with section 5353 of the House bill.

The section will enable responsible warehouse companies or other responsible persons to establish facilities on bonded wine cellar premises for the storage of wines and allied products for credit purposes. The proprietor of the bonded wine cellar will remain liable for the tax while the wine is so held for credit purposes. Under existing law (sec. 3040) it was necessary that such credit warehouse be established as a bonded wine storeroom, which necessitated the warehouseman filing a bond and rendering reports covering operations of a bonded wine storeroom. The change simplifies operations by the warehouseman and the proprietor of the bonded wine cellar, as well as the administrative handling by the Government.

Section 5354. Bond

This section is identical with section 5354 of the House bill.

The section makes three changes in existing law (secs. 3031, 3040), the first change is to state the minimum as well as the maximum penal sum for bonds covering operations of bonded wine cellars. The existing maximum of $50,000 is raised to $100,000 in such instances where the tax liability on wine or wine spirits exceeds $250,000.

The second change is to provide for a bond in addition to that referred to in the preceding paragraph where additional liability arises as a result of taxpayment by return instead of stamp.

The third change is that the bond of the bonded wine cellar shall apply whether the transaction or operation occurred on or off the proprietor's premises. This change is to cover liability in respect to wines in transit from one part of a bonded wine cellar to a noncontiguous part.

Section 5355. General provisions relating to bonds

This section corresponds to section 5355 of the House bill, which was a cross reference section relating to disapproval of bonds. Your committee has changed the section from a cross reference to an applicability section in order to make section 5551 specifically applicable to bonds covering bonded wine cellar operations.

Section 5356. Application

This section is identical with section 5356 of the House bill.

The section makes two changes in existing law (sec. 3040).

It requires that a person desiring to establish a bonded wine cellar or a taxpaid wine-bottling house must file an application and obtain approval thereof prior to operations. Under existing law any person desiring to establish a bonded winery or bonded wine storeroom is required to file a notice which does not require approval prior to commencement of operations. Also, anyone could bottle taxpaid wine without filing a notice or obtaining permission from the Government;

Section 5357. Premises

This section is identical with section 5357 of the House bill.

The section makes one change in existing law (sec. 3040).

It requires that bonded wine-cellar premises be constructed and equipped in such manner as to afford adequate protection to the revenue, and recognizes the propriety of having portions of the premises separated by territory not under the control of the proprietor, subject to regulations prescribed by the Secretary or his delegate. Existing law merely required that the bonded winery or bonded-wine-storeroom premises be described.

Part II—Operations

Section 5361. Bonded wine cellar operations

This section is identical with section 5361 of the House bill.

The section makes two important changes in existing law (sec. 3040). There are also clarifying changes.

The first change is to authorize the receipt on bonded wine cellar premises of taxpaid wines for return to bond, reconditioning, or destruction. This will enable the proprietor to use the bonded premises for the storage of taxpaid wines and the reconditioning of such wines, subject to limitations prescribed by the Secretary or his delegate. Existing law did not make provision for such operations and it was necessary that taxpaid wines be stored off bonded premises. This change will give winemakers more freedom of operations without jeopardizing the revenue.

The second change is to authorize the use of the bonded premises for operations conducted in a manner that will not jeopardize the revenue or conflict with wine operations. This enables winemakers to use equipment for the bottling of fruit juices, the preparation of jellies, jams, etc., and thus avoid the expense of duplicating equipment off bonded premises.

The clarifying changes are to recognize the propriety of manufacturing on bonded wine-cellar premises heavy bodied blending wines for perfecting beverage wines according to standard, and Spanish-type blending sherry for use by rectifiers in manufacturing blended whisky. Although these operations are now permitted there has been no clear basis in law for the production of these wines which are not intended for consumption or sale as beverage wines.

Section 5362. Removals of wines from bonded premises

This section is identical with section 5362 of the House bill.

The section makes three changes in the law. See sections 3037 and 3038.

The first change permits the tax-free withdrawal of wine from bonded wine cellars for experimental or research purposes by a university, college of learning, or institution of scientific research. This will permit such institutions to obtain wines from various bonded wine cellars for analysis, testing and research purposes, without having to pay tax on the wine. This is similar in purpose to section 5042 (a) (3) which permits the experimental production of wine by such institutions.

The second change permits the tax-free withdrawal of wine for analysis or testing, organoleptically or otherwise. This has been handled administratively so that winemakers not having laboratories on the bonded premises could send wines to commercial laboratories for analysis or testing.

The third change is to allow the tax-free withdrawal of wine by the governments of the several States and Territories and the District of Columbia for analysis or testing in connection with the sale of wines in their jurisdictions.

Provisions in existing law authorizing transfers to other bonded wine cellars, exportation, transfer to foreign trade zones, use on vessels and aircraft, transfer to customs manufacturing warehouse, transfer for manufacture of vinegar, transfer for use as distilling material, and use by the United States Government have been retained.

Section 5363. Taxpaid wine bottling house operations

This section is identical with section 5363 of the House bill.

The section makes one important change in existing law.

Persons authorized to bottle taxpaid wine may mix together lots of wine of the same kind and taxable grade to facilitate handling; preserve, filter, and clarify wine; and conduct operations not involving wine where such operations will not jeopardize the revenue or conflict with wine operations. Under existing law any mixing or blending of taxpaid wines must be done on premises of a rectifier and be for the sole purpose of perfecting the wines according to commercial standards to be exempt from the rectification tax. The mixing of wines to facilitate handling would under existing law require payment of the rectification tax of 30 cents a proof gallon. This section enables bottlers, upon receipt of a new shipment of wine, to deposit it in a storage tank with the remnant of a prior shipment of the same kind of wine. It also enables the bottlers to preserve wine by the use of approved materials or methods (such as sulphur, pasteurization), and to filter or clarify wine to remove cloudiness or sediment. Operations, such as the bottling of soft drinks, may be carried on by taxpaid wine bottlers, if such is done in a way not to interfere with determinations by Government officers regarding the nature and extent of wine operations.

Section 5364. Standard wine premises

This section is identical with section 5364 of the House bill.

It requires that substandard beverage wine be produced and stored on premises separate from those used for standard beverage wine. The purpose for the separation is to make it difficult for the substitution of the substandard wine for the standard product. Under existing law substandard beverage wines, that is, wines in which water is used in excess of limitations prescribed for standard wines, have been produced on the same premises as standard wines. This made it comparatively easy for unscrupulous persons to substitute the substandard product for the standard wine. This section would not preclude the production or handling on standard wine premises of distilling material, vinegar stock, blending wines, or wines fermented to a high percentage of alcohol with excess sugar. Wines in the last category conform to requirements for standard wines with the single exception that the finished product has 14 percent or more of alcohol after complete fermentation or complete fermentation and sweetening. These wines usually contain about 15 or 16 percent of alcohol and are now required to have on the label the explanatory information "fermented with excess sugar."

Section 5365. Segregation of operations

This section is identical with section 5365 of the House bill.

There have been instances where artificially carbonated wine has been substituted by unscrupulous winemakers for champagne or other sparkling wine, thus perpetrating a fraud on the revenue and on the consumer. There have also been times when untaxpaid wines have been substituted for taxpaid wines. The segregation of operations, where deemed necessary, will afford the Government better control of operations.

Section 5366. Supervision

This section is identical with section 5366 of the House bill.

The section clarifies existing law (secs. 3034, 3035, 3042) regarding supervision of operations at bonded wine cellars and extends the authority to taxpaid wine bottling houses. Operations at some premises do not require the same degree of supervision as operations at other premises. This section enables the Secretary or his delegate to vary supervision at premises so long as the supervision is adequate to protect the revenues and is consistent with proper enforcement of this subchapter.

Section 5367. Records

This section is identical with section 5367 of the House bill.

The section is consistent with requirements of existing law (sec. 3171) regarding records to be maintained and filed by producers of wine, and extends the recordkeeping requirement to taxpaid wine bottling houses.

Section 5368. Gauging, marking, and stamping

This section is identical with section 5368 of the House bill and clarifies existing requirements of law (secs. 3030, 3040, 3041).

Section 5369. Inventories

This section is identical with section 5369 of the House bill and is of the same force and effect as the existing provision of law (sec. 3040).

Section 5370. Losses

This section is identical with section 5370 of the House bill.

The section makes two important changes in existing law (sec. 3039).

The first change is that all losses of wine on bonded wine-cellar premises are allowable except losses due to theft occurring with connivance, collusion, fraud, or negligence on the part of the proprietor, owner, consignor, consignee, bailee, or carrier or the agents or employees of any of them, or where the losses are due to unauthorized voluntary destruction. Under existing law all losses of wine due to theft, or the voluntary destruction of marketable wine, have been taxed. Where there is a loss by theft under the new law, the burden of proof showing that the wine tax should not be collected lies with the proprietor of the bonded wine cellar.

The other change in existing law is that it will no longer be necessary for the proprietor of the bonded wine cellar to show that wine is unfit for use as such or is unmarketable, to obtain destruction free of tax. Good wine may be destroyed free of tax by the proprietor under Government supervision or upon adequate notice to and approval by the Secretary or his delegate.

Section 5371. Insurance coverage

This section is identical with section 5371 of the House bill.

The new section provides that allowance for losses of wine, refund of tax, or relief from tax, shall be allowed only to the extent the claimant is not indemnified or recompensed for the tax.

Section 5372. Sampling

This section is identical with section 5372 of the House bill.

This is a new provision of law. Winemakers have been allowed to use wine on bonded wine cellar premises for analysis or testing;

however, any tasting or sampling of wine free of tax by agents or prospective customers has not been authorized. Under the new law the use of wine free of tax for tasting and sampling on bonded wine-cellar premises will be permissible under limitations prescribed by regulations.

Section 5373. Wine spirits

This section corresponds to section 5373 of the House bill. Your committee has amended paragraph (2) of subsection (b). The language of subsection (b) (2) as passed by the House lends itself to interpretation that the proprietor of a bonded wine cellar may remove unused wine spirits without regard to the limitation stated in the Federal Alcohol Administration Act (27 U. S. C., sec. 206) regarding persons who may receive distilled spirits in bulk. The paragraph has been amended by your committee so that there may be no doubt as to the intent not to change existing law.

This section makes six important changes in existing law (secs. 3031, 3032, 3036).

The first change is that it prescribes limitations as to proof of brandy or wine spirits which may be used in the fortification of wine. This is done to prevent the watering of wine under guise of a legitimate operation. Brandy may have a proof as low as 80 degrees. Unscrupulous distillers could reduce the distillation proof of brandy or wine spirits by the addition of water and thus defeat the limitations imposed by sections 5383 and 5384 regarding the addition of water in the production of natural wines. The limitation as to proof does not apply in respect to brandy aged in wood for a period of at least 2 years and barreled at not less than 100 degrees proof. Winemakers desiring to circumvent the limitation regarding the use of water would not use such brandy.

The second change is that wine spirits may be added to grape juice or to concentrated grape juice to be used in the cellar treatment of wine. This facilitates the use of grape juice and concentrated grape juice for such purpose. Basically, it is not a material departure from practices under existing law, since grape juice containing one-half of 1 percent or more of alcohol is, for accounting and taxing purpose, considered wine.

The third change is to permit the use on bonded wine-cellar premises of tax-free brandy or wine spirits in the preparation of dosage for sparkling wine or the preparation of alcoholic essences for use in the manufacture of vermouth or other special (flavored) natural wines. Under existing law only taxpaid distilled spirits could be used for these purposes. The volume of brandy or wine spirits so used is very small.

The fourth change is that where the proprietor has used wine spirits in actual wine production, but in violation of requirements of this subchapter, he is given credit for the brandy the same as if he had used it within the limitations, provided he shows he did not knowingly misuse the wine spirits in wine production. A statement regarding this credit is made under section 5391.

The fifth change is that wine spirits withdrawn by the proprietor of a bonded wine cellar and not used in wine production may be transferred to another bonded wine cellar. This facilitates the disposition of wine spirits for which a winemaker no longer has use. Existing law authorizes the return of wine spirits to internal revenue bonded warehouses or taxpayment (sec. 3034).

The sixth change is that samples of brandy or wine spirits are authorized to be withdrawn free of tax from any registered fruit distillery, internal revenue bonded warehouse, bonded wine cellar, or authorized experimental premises, for analysis or testing. Existing law (sec. 3037) does not specify the kind of premises from which such samples may be withdrawn.

Part III—Cellar Treatment and Classification of Wines

Section 5381. Natural wine

This section is identical with section 5381 of the House bill.

The section is a clarification and simplification of existing law (secs. 3036, 3044, 3045) by merging into a single definition existing definitions for pure sweet wine, natural grape wine, wine, and fruit and berry wines. The definition, instead of placing a limit on the quantity of sweetening material which may be added, substitutes a limit of 21 percent by weight on the total solids content of the finished wine. This maximum solids content could be attained under existing law.

Section 5382. Cellar treatment of natural wine

This section is identical with section 5382 of the House bill.

The section makes eight important changes in existing law (secs. 3036, 3044).

The most important change is authority to use methods and materials to correct and stabilize wine, or the fruit juice from which it is made, so as to produce a finished product acceptable in good commercial practice. The test of permissible cellar treatment in existing law is "usual" cellar treatment. The new test is "acceptable in good commercial practice." Under this section a practice or procedure not heretofore authorized must be shown to be a good commercial practice. The mere showing by a winemaker that he has used a method or material or that some other person has used it would not in itself be an adequate showing.

The second change is that unconcentrated as well as concentrated fruit juice may be used in the cellar treatment of wine. Existing law authorizes the use of concentrated juice. Wine spirits or brandy may be added to the juice or to the concentrated juice prior to its addition to the wine. This will facilitate the preparation of a wine conforming to commercial standards.

The third change is to authorize grape juice having an unusually high solids content to be reduced with water to 22 degrees solids by weight. This enables the production by complete fermentation of a dry (not sweet) wine having less than 14 percent of alcohol. Grapes in some regions have an abnormally high sugar content.

The fourth change is to specifically provide for the preparation of still wine for refermentation, and the preparation of dosage, in the production of champagne and other sparkling wines. The only reference in existing law to champagne and other sparkling wine is the imposition of the tax thereon.

The fifth change is to permit any blending on bonded wine cellar premises of wines made from the same kind of fruit. For accounting purposes the mixing of juice or concentrated juice, to which wine spirits have been added, with wines is considered a blending of wines.

Existing law permitted the blending of wines on bonded winery premises only for the purpose of perfecting wines according to commercial standards. Administration of the existing limitation has been difficult and unsatisfactory since the question of what constitutes perfecting according to commercial standards is highly debatable. Under the new law the winemaker may use his discretion in blending together wines made from the same kind of fruit, subject to the appropriate labeling of the blended product.

The sixth change is a specific authority to use acids to correct natural deficiencies and to stabilize wine. While the addition of acids to wine is not specifically authorized by present law (sec. 3036), such cellar treatment has been determined to be necessary in some regions to produce a grape wine conforming to generally accepted standards for wines. California grapes are comparatively low in natural acids. Occasionally, because of soil and climate conditions the acid content of the grapes is abnormally low. Acids must be added to wine produced from such grapes, to stabilize the wine as well as to make it conform to accepted standards.

The seventh change is to recognize the propriety of the natural darkening of juice or wine. Existing law is silent on this subject and administrative difficulties have been encountered in respect to the baking of wine and the concentration of fruit juice. This change in the law contemplates no more than an incidental caramelization of sugar during the baking of wine or concentration of juice. It does not authorize the addition of caramel as such or the purposeful caramelization of concentrate intended for use in the cellar treatment of wine.

The eighth change in the law is the specific authorization for the Secretary to prescribe limitations on the preparation and use of clarifying, stabilizing, preserving, fermenting, and corrective methods or materials to the extent that such preparation or use is not acceptable in good commercial practice. Existing law is silent on this subject and much difficulty has been experienced in determining acceptable practices.

Section 5383. Amelioration and sweetening limitations for natural grape wine

This section corresponds to section 5383 of the House bill. Your committee has amended paragraph (1) of subsection (b) to read as follows:

> "(1) Any natural grape wine of a winemaker's own production may, under this subsection, be ameliorated to correct high acid content, and, whether or not ameliorated, may be reserved as herein provided."

This change is for clarification and was made to make paragraph (1) consistent with paragraph (2) of subsection (b) and the intent of section 5383.

The section makes seven important changes in existing law (secs. 3036; 3044).

The first change is to allow the addition of pure dry sugar to the extent necessary to have a sugar solids content not exceeding 10 percent of the weight of the wine. Such a limitation is approximately the equivalent of existing law which permits the addition to wine of sugar not exceeding 11 percent of the weight of the wine. The change was made because a test of the finished product must be made in any event to determine whether the wine conforms to standards acceptable in good commercial practice.

The second change is to allow addition to the juice or to the wine of sugar and water, separately or in combination, instead of the existing authority to add a sugar-water solution where high acid grapes are used. The limitations, that the ameliorating material shall not exceed 35 percent of the volume of the resultant product and that the acid content may not be reduced below five parts per thousand, are retained. The limitation as to acid content is clarified by requiring that the calculation must be made before fermentation and as tartaric acid.

The third change is to raise the 13 percent alcohol limitation after complete fermentation or complete fermentation and sweetening to "less than 14 percent." This is a logical limitation since wine containing more than 14 percent of alcohol is subject to a higher rate of tax than wine having not over 14 percent of alcohol.

The fourth change is that where wines are to be further sweetened or have wine spirits added they are required to be accounted for in a "reserve inventory." The change was made to permit a determination on an overall basis, rather than on an individual lot basis, of the amount of sugar available for further amelioration or sweetening.

The fifth change deletes the existing authority to employ unused sugar-water solution, not used in amelioration, for sweetening purposes. Instead, the use of an equivalent weight of dry sugar for sweetening in the reserve inventory is authorized. The wines may not in any event have a higher solids content than is authorized under existing standards. The limitation in existing law that sweetening material may not be added after fortification has been deleted.

The sixth change is to authorize the blending of lots of wine and the addition of wine spirits while wine is being held for further sweetening in the "reserve inventory."

The seventh change is to require winemakers holding wine for further sweetening to maintain and balance accounts as to wine in the "reserve inventory." Winemakers need not use the "reserve inventory" unless they desire to further sweeten their high acid wines or add wine spirits.

Section 5384. Amelioration and sweetening limitations for natural fruit and berry wines

This section corresponds to section 5384 of the House bill. Subsection (b) (2) of this section provides that the provisions of section 5383 (b), with certain exceptions not here pertinent, shall apply to the treatment of fruit and berry wines. The amendment of section 5383 (b) (1) made by your committee necessitated for clarity a corresponding amendment of section 5384 (b) (1) by your committee to read as follows:

> "(1) Any natural fruit or berry wine (other than grape wine) of a winemaker's own production may, if not made under subsection (a) of this section, be ameliorated to correct high acid content, and, whether or not ameliorated, may be reserved as herein provided. Separate reserve inventories shall be established for wines made from each different kind of fruit."

Section 5385. Specially sweetened natural wines

This section is identical with section 5385 of the House bill.

The section makes an important change in that it recognizes an extremely sweet wine as a standard wine. There is no similar provision in existing law. Winemakers were permitted to make such wines (usually by fermenting to over 14 percent alcohol and reducing the alcohol below that degree with sweetening sugar), but since sugar was used in excess of limitations authorized for standard wines, the wines were required to be classified as nonstandard wines. The commercial labels on such wines must appropriately disclose that the product is unusually sweet.

Section 5386. Special natural wines

This section is identical with section 5386 of the House bill.

The section changes existing law (sec. 2801 (e) (4)) by extending the privilege of manufacturing vermouth and aperitif wines to other wines which derive their flavor from herbs, spices, aromatics, etc. It is not the intent of this section to authorize the production of fruit flavored wines, such as a blackberry flavored grape wine. Under existing law flavored wines other than vermouth and aperitif wines may be made only at a rectifying plant subject to the payment of the 30 cents a proof gallon rectification tax.

Section 5387. Agricultural wines

This section corresponds to section 5387 of the House bill. Your committee has amended subsection (a) by inserting the words "the juice of" before the word "fruit" where it appears in the first line of this subsection. It is intended that this section of law cover, among other wines, wines made from dried fruit. This change has been made for the purpose of making clear this intent.

These wines are not specifically referred to in existing law. This addition to the law enables the setting up by regulations of standards for agricultural wines after experience has shown to what extent provisions of law relating to natural wines should be considered applicable. Uniform limitations cannot be prescribed for all agricultural wines. Limitations consistent with good commercial practices in respect to the production of dried fruit wines could not be prescribed for other wines, such as honey wine, rhubarb wine, etc.

Section 5388. Designation of wines

This section is identical with section 5388 of the House bill.

The section is a change in existing law (sec. 3044) in that it extends the provision with respect to appropriate labeling or marking to all standard and substandard wines to prevent confusion or misunderstanding regarding the kind of wine.

Part IV—General

Section 5391. Exemption from rectification and spirits taxes

This section is identical with section 5391 of the House bill.

The section contains two important changes in existing law (secs. 2801 (c); 2801 (e) (3); 3031 (a)).

The first change is that a specific declaration is made that winemakers adding material to wine or otherwise treating wine, within the limitations prescribed by wine law, are not subject to the taxes imposed in respect to rectified spirits and wines. This is generally true under existing law, but it is not clearly stated.

The section contains a provision new to internal revenue law. This would also exempt from rectification and distilled spirits taxes the winemaker who adds material to wine or treats wine in violation of law but shows he did not knowingly violate the law. The reason for this exemption, where the winemaker did not knowingly violate the law, is that these tax liabilities are in the nature of an enforcement aid rather than a specific source of revenue. For example, if under the provisions of section 5383 a winemaker were entitled to use sugar and water in an amount of 100 gallons but due to miscalculation or other mistake added 110 gallons and then fortified the wine with wine spirits, existing law would make the winemaker liable for tax of $10.50 for each proof gallon of wine spirits used and, in addition, a rectification tax of 30 cents a proof gallon on the entire lot of wine produced. Such a tax liability would be far out of proportion to the gravity of the offense. This section of law relieves the winemaker of such tax liability where he shows he did not knowingly violate the law. He is still liable under the penalty provisions for violating the law, and the wine tax is collected in the usual manner upon removal of the wine from bond. Heretofore, it has been the practice to compromise tax liabilities of the type described, where the violations were technical or there was doubt as to liability, and the violations were not willful or with intent to defraud.

Section 5392. Definitions

This section is identical with section 5392 of the House bill.

The definitions given in this section are not in existing law relating to wine (secs. 3030-3045). They have been added for purposes of clarification.

SUBCHAPTER G—BREWERIES

It is the intention of your committee that wherever in this subchapter the Secretary or his delegate is authorized to prescribe regulations, such authority shall be exercised only to the extent "necessary to protect and insure collection of the revenue."

PART I—ESTABLISHMENT

Section 5401. Qualifying documents

This section corresponds to section 5401 of the House bill with the exception of two changes which were made by your committee.

Subsection (a) relating to the notice filed by brewers before commencing or continuing business in substance represents existing law (sec. 3155 (a)) except for the form and contents of the notice have been left to the regulations prescribed by the Secretary or his delegate. Your committee restored the language contained in existing law which has been construed as authorizing the Secretary or his delegate to require notice of changes in ownership or operation by brewers since such information is of material value with regard to the brewer's bond.

Subsection (b) represents existing law (secs. 3153 (b) and 3155 (b)) with the following exceptions:

(1) The maximum penal sum of the brewer's bond, which under existing law is $100,000, has been eliminated. The reason for this change is that the liability of the bond has been increased and it may be necessary to increase the Government's security. Under existing law the tax on beer is paid by stamps when the beer is removed for consumption or sale, and therefore the risk of the surety is limited to possible fraud on the part of the brewer. Under the method of tax payment by return provided for in section 5061, it may be necessary for the surety to underwrite a much greater liability.

(2) The second change in this subsection is that the condition of the brewer's bond has been enlarged to include liability for beer removed for export and liability for beer received from other breweries operated by the same brewer. This first enlargement eliminates the necessity for separate export bonds required by existing law (sec. 3153 (b)). The second enlargement covers a new provision of removals from one brewery to another belonging to the same brewer, which is granted by section 5414.

Your committee amended subsection (b) to conform to the change made in section 5053 (a) relating to the exportation of beer. The effect of this change is to condition the brewer's bond upon exportation of beer rather than delivery of such beer to custom's custody.

Section 5402. Definitions

This section is identical with section 5402 of the House bill and gives the word "brewery" the same meaning as the words "brewery premises" as set forth in section 3158 of existing law.

Section 5403. Cross-references

This section is identical with section 5403 of the House bill and contains cross-references to sections of law applicable to the establishment of breweries.

Part II—Operations

Section 5411. Use of brewery

This section is identical with section 5411 of the House bill.

The section makes two major changes in existing law (sec. 3158). The first change authorizes the use of brewery premises for producing and bottling soft drinks and for such other purposes as the Secretary may find will not jeopardize the revenue. Bottling and canning equipment is very expensive, and, in many cases, cannot be operated at full capacity in the bottling of beer. By allowing the use of such equipment for bottling soft drinks and similar products, the maximum benefit of this expensive equipment can be realized and the overhead of the plant reduced.

The second change in existing law provides that beer and cereal beverages shall be bottled only in the brewery bottling house, which shall consist of a separate portion of the brewery designated for that purpose. This provision would, however, permit a connecting doorway between the bottling house and other portions of the brewery. With proper regulatory requirements, it would appear that such a connecting door would not jeopardize the revenue.

Section 5412. Removal of beer in containers or by pipeline

This section is identical with section 5412 of the House bill.

The section is a substantial restatement of existing law (sec. 3104) except that it leaves to regulations the manner of marking and branding hogsheads, barrels, and kegs in which beer is removed from breweries. The authority to remove beer by pipeline to a contiguous industrial alcohol plant provided in existing law (sec. 3155 (f)) is retained without change.

Section 5413. Brewers procuring beer from other brewers

This section is identical with section 5413 of the House bill and represents existing law. (See the proviso portion of sec. 3155 (f).)

Section 5414. Removals from one brewery to another belonging to same brewer

This section is identical with section 5414 of the House bill.

The section authorizes a brewer owning two or more breweries to remove beer untaxpaid from one plant to another under such regulations as the Secretary shall prescribe. This section further provides that the brewery to which the beer is removed shall pay the tax on such beer in the manner provided by section 5061. All such transfers will be covered by the brewer's bond. Existing law does not provide for such transfers in the case of beer. However, the authority granted under this section is comparable to existing provisions in-bond transfers of wines and distilled spirits. Transfers of beer under this section would be covered by the brewer's bond.

Section 5415. Records and returns

This section is identical with section 5415 of the House bill.

The section is a restatement of existing law (sec. 3155 (c)), except that it leaves to regulations the details concerning records to be kept. It provides further that such records shall be maintained for a period of at least 2 years and shall be available for inspection by internal-revenue officers during business hours.

Section 5416. Definition

This section is identical with section 5416 of the House bill.

The section defines the word "bottle" to include cans and other similar containers as a matter of convenience and to avoid unnecessary repetition of the word "can" in other sections of the statute.

SUBCHAPTER H—MISCELLANEOUS PLANTS AND WAREHOUSES

PART I—VINEGAR FACTORIES

Section 5501. Establishment and operation

This section is identical with section 5501 of the House bill and is a cross-reference section only.

Section 5502. Distilled vinegar

This section is identical with section 5502 of the House bill and represents existing law. See section 3110.

PART II—VOLATILE FRUIT-FLAVOR CONCENTRATE PLANTS

Section 5511. Establishment and operation

This section is identical with section 5511 of the House bill and represents existing law. See section 3182 (a).

Section 5512. Control of products after tax-free manufacture

This section is identical with section 5512 of the House bill and is a cross-reference section only.

PART III—MANUFACTURING BONDED WAREHOUSES

Section 5521. Establishment and operation

This section corresponds to section 5521 of the House bill. Your committee has made a technical correction in paragraph (1) of subsection (d) by inserting a comma on the fourth line after the word "delegate" and preceding the word "without". This correction does not alter the meaning or intent of the language but is necessary for a proper reading of the sentence.

The section is existing law (sec. 3177 (a)), except that the provisions of paragraph 2 of subsection (d) have been revised to conform to current customs procedures.

Section 5522. Withdrawal of distilled spirits to manufacturing bonded warehouses

This section corresponds to section 5522 of the House bill. Your committee has amended subsection (b) by deleting the cross-reference and substituting therefor a provision making section 5011 (a) specifically applicable to losses of distilled spirits withdrawn for transportation to manufacturing bonded warehouses. This change makes section 5522 (b) consistent with the provisions of section 5247 (e) and does not change the intent of the language but is merely for purposes of clarification.

Subsection (a) "Authorization" represents existing provisions of law for the transfer of spirits to customs manufacturing warehouses, except that the limiting requirement that the withdrawals shall be in original packages only has been deleted (sec. 2891 (a)). This change is consistent with present provisions of existing law relating to the withdrawal of distilled spirits from internal-revenue bonded warehouses for other purposes. The Secretary or his delegate will be authorized to prescribe by regulations the methods by which spirits may be removed from an internal-revenue bonded warehouse to a customs manufacturing bonded warehouse.

Subsection (b) specifically makes applicable to losses during transportation to manufacturing bonded warehouses the provisions of section 5011 (a) relative to allowance for losses of distilled spirits in bond.

Section 5523. Special provisions relating to distilled spirits and wines rectified in manufacturing bonded warehouses

This section is identical with section 5523 of the House bill.

Section represents existing provisions of law (sec. 3178), except that the words "or packaged" have been added in the phrase "which are reduced in proof and bottled or packaged in such warehouses." The purpose of this change is to permit reduction in proof and packaging in manufacturing bonded warehouses.

SUBCHAPTER I—MISCELLANEOUS GENERAL PROVISIONS

Section 5551. General provisions relating to bonds

This section is identical with section 5551 of the House bill and represents existing law. See section 2815 (c), (d), and (e).

Section 5552. Installation of meters, tanks and other apparatus

This section is identical with section 5552 of the House bill.

The existing law (sec. 2829) authorizes the Secretary or his delegate to require at distilleries, breweries, rectifying plants or wherever else in his judgment such action may be deemed advisable, meters, tanks, etc. The statement "wherever else" is too vague and has been changed to read "at any other premises established pursuant to this chapter" for purposes of clarification.

Section 5553. Supervision of premises and operations

This section is identical with section 5553 of the House bill.

Subsection (a), relating to the assignment of storekeeper-gaugers, gives clear statutory basis to the Secretary or his delegate for the assignment of gaugers to any premises established under the provisions of this chapter. This is a clarification of existing law and makes no substantive change.

Subsection (b), relating to the functions of storekeeper-gaugers, has been inserted for the purpose of clarifying the meaning of the term "storekeeper-gauger" as used in this chapter.

Section 5554. Pilot plant operations

This section corresponds to section 5554 of the House bill except that provision has been made for waiver of provisions of chapter 26 of the Internal Revenue Code of 1939 since your committee has made this section effective on date of enactment.

The section would permit the Secretary or his delegate to use, with the approval of the proprietors, certain plants, such as distilleries, as a basis for experimentation in the development and testing of improved methods of governmental supervision, and would authorize the waiving for such temporary pilot or experimental operations, of such regulatory provisions of this chapter, or of chapter 26 of the Internal Revenue Code of 1939, as may be necessary to conduct such temporary pilo or experimental operations.

Section 5555. Records, statements, and returns

This section is identical with section 5555 of the House bill.

Subsection (a) is existing law (section 3171) except that the words "or for the affixing of any stamps required to be affixed by this chapter" have been inserted for the purpose of giving clear statutory authority over persons who bottle or package taxable products after withdrawal from bond and who affix thereto stamps evidencing the tax or compliance with the provisions of this chapter. This provision is considered a definite protection to the revenue since it is essential that some control be maintained over persons who bottle or package taxable articles and affix thereto stamps prescribed by law. This subsection would have particular application in the case of distilled spirits bottled after determination or payment of tax and to which were affixed strip stamps provided for in section 5008 (b). Such operations are presently controlled by regulations based upon constructive statutory authority for the enforcement of existing provision of law. However, it is deemed desirable to make the statutory basis for such regulations more specific.

Subsection (b) is a new provision authorizing the Secretary or his delegate to waive, by regulation in whole or in part, the requirement for the making of any statement, record, or return when he deems such requirement to no longer serve a necessary purpose. This provision is cons'dered highly desirable in view of the large number of records and returns required to be made under this chapter. It has been found that due to changing conditions, records or statements which at one time served a useful purpose may no longer be of value or are superseded by some other requirement. It has also been found that in certain cases the specific detail required to be shown on certain records or returns is no longer of value. It has been impossible in the past to eliminate such detail or requirements, even when obsolete, without specific legislative action.

Section 5556. Regulations

This section is identical with section 5556 of the House bill and represents existing law. See section 3176.

Section 5557. Other laws applicable

This section is identical with section 5557 of the House bill.

The chapter on distilled spirits, wines, and beer contains certain specific administrative and procedural requirements, and it is intended that in case of inconsistency between the general provisions contained in subtitle F, the specific provisions in this chapter should govern. However, to the extent to which they are not inconsistent with the provisions of this chapter it is intended that the general provisions of subtitle F, relating to procedure and administration, have full force and effect insofar as this chapter is concerned. This section has been made applicable to chapters 52 and 53 in a like manner.

SUBCHAPTER J—PENALTIES, SEIZURES, AND FORFEITURES RELATING TO LIQUORS

Part I—Penalty, Seizure, and Forfeiture Provisions Applicable to Distilling, Rectifying, and Distilled and Rectified Products

Section 5601. Penalty and forfeiture for possession of unregistered still or distilling apparatus

This section is identical with section 5601 of the House bill and changes section 2810, Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5602. Penalty and forfeiture for setting up still without permit

This section is identical with section 5602 of the House bill and represents existing law.

Section 5603. Penalty for failure or refusal of distiller or rectifier to give notice of intention to engage in such business

This section is identical with section 5603 of the House bill and changes section 2812, Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5604. Penalty and forfeiture for failure or refusal of distiller to give bond

This section is identical with section 5604 of the House bill and changes section 2814 (a) (1), Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5605. Penalty for improper approval of distiller's bond

This section is identical with section 5605 of the House bill and represents existing law.

Section 5606. Penalty and forfeiture for distilling without giving bond

This section is identical with section 5606 of the House bill and changes section 2833 (a), Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5607. Penalty for distilling on prohibited premises

This section is identical with section 5607 of the House bill and changes section 2819, Internal Revenue Code (1939), only to the extent of omitting the minimum imprisonment.

Section 5608. Penalty for making or fermenting mash on unauthorized premises; illegal use of spirits; unlawful removal of vinegar; etc.

This section is identical with section 5608 of the House bill, which changes section 2834, Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment: *Provided, however,* That subsection (a) thereof has been amended by striking out the word "provisions" and inserting in lieu thereof the word "provision".

Section 5609. Penalty relating to return of materials used in the manufacture of distilled spirits

This section is identical with section 5609 of the House bill and represents existing law.

Section 5610. Penalty for using unregistered materials for producing spirits

This section is identical with section 5610 of the House bill and represents existing law.

Section 5611. Penalty for using false weights and measures

This section is identical with section 5611 of the House bill and changes section 2842, Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5612. Penalty for using material or removing spirits without supervision

This section is identical with section 5612 of the House bill and represents existing law.

Section 5613. Penalty for distilling during prohibited hours

This section is identical with section 5613 of the House bill and represents existing law.

Section 5614. Penalty and forfeiture for removal of spirits during prohibited hours

This section is identical with section 5614 of the House bill and represents existing law.

Section 5615. Penalty for refusal or neglect of distillers and rectifiers to give assistance to officers

This section is identical with section 5615 of the House bill and represents existing law.

Section 5616. Penalty for obstructing or refusing to admit officer to distillery premises

This section is identical with section 5616 of the House bill and represents existing law.

Section 5617. Penalty for failure to keep distillery accessible

This section is identical with section 5617 of the House bill and represents existing law.

Section 5618. Penalty for failure of distiller to identify fixed pipes

This section is identical with section 5618 of the House bill and represents existing law.

Section 5619. Penalty for refusal or neglect to draw off water and clean condensers or worm tanks

This section is identical with section 5619 of the House bill and represents existing law.

Section 5620. Penalty and forfeiture for false or omitted entries in distiller's books and records

This section is identical with section 5620 of the House bill and changes section 2841 (c) (1), Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5621. Penalty relating to records and returns of distillers as wholesale dealers, rectifiers, and wholesale dealers

This section is identical with section 5621 of the House bill and changes sections 2859 (a) and 2857 (a), Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5622. Disposal of forfeited equipment and material for distilling

This section is identical with section 5622 of the House bill and represents existing law.

Section 5623. Destruction of distilling apparatus

This section is identical with section 5623 of the House bill and changes section 2853 (a), Internal Revenue Code (1939), by omitting the limitations respecting capacity and value. The omissions are necessitated by modern conditions in connection with illicit distilling.

Section 5624. Release of distillery before judgment

This section is identical with section 5624 of the House bill and represents existing law.

Section 5625. Forfeiture of taxpaid distilled spirits remaining on distillery premises

This section is identical with section 5625 of the House bill and represents existing law.

Section 5626. Penalty and forfeiture for tax fraud by distiller

This section is identical with section 5626 of the House bill and changes section 2806 (f), Internal Revenue Code (1939), only to the extent of omitting the minimum fine and imprisonment.

Section 5627. Penalty for unlawful use of rectifying premises

This section is identical with section 5627 of the House bill and represents existing law.

Section 5628. Penalty for rectification without payment of tax, increasing volume, etc.

This section is identical with section 5628 of the House bill and changes section 2801 (f), Internal Revenue Code (1939), only to the extent of dropping the denomination of the offense as a misdemeanor.

Section 5629. Penalty for unlawful rectifying

This section is identical with section 5629 of the House bill and changes section 2856, Internal Revenue Code (1939), by omitting the minimum fine and imprisonment therein provided.

Section 5630. Penalty for noncompliance by rectifiers with provisions relating to rectifying, gauging, branding, and stamping

This section is identical with section 5630 of the House bill and changes section 2865 (a), Internal Revenue Code (1939), by omitting the minimum fine.

Section 5631. Penalty and forfeiture for failure to comply with warehousing and removal requirements

This section is identical with section 5631 of the House bill and changes section 2876, Internal Revenue Code (1939), by omitting the minimum fine and imprisonment.

Section 5632. Penalty and forfeiture for unlawful removal or concealment of spirits

This section is identical with section 5632 of the House bill and omits the minimum fine and imprisonment provided in sections 2912 and 2913, Internal Revenue Code (1939).

Section 5633. Penalty on officer in charge of warehouse for unlawful removal of spirits

This section is identical with section 5633 of the House bill and omits the minimum fine and imprisonment provided in section 2914 (a), Internal Revenue Code (1939).

Section 5634. Penalty and forfeiture for creation of fictitious proof

This section is identical with section 5634 of the House bill and represents existing law.

Section 5635. Penalty for buying or selling used casks bearing inspection marks

This section is identical with section 5635 of the House bill and represents existing law.

Section 5636. Penalty and forfeiture for failure to efface, etc., stamps and brands on emptied packages

This section is identical with section 5636 of the House bill and omits the minimum fine and imprisonment provided in section 2866, Internal Revenue Code (1939).

Section 5637. Penalty for changing stamps or shifting spirits

This section is identical with section 5637 of the House bill and omits the minimum fine and imprisonment provided by section 2868, Internal Revenue Code (1939).

Section 5638. Penalty and forfeiture for affixing imitation stamps on packages of distilled spirits

This section is identical with section 5638 of the House bill and represents existing law.

Section 5639. Forfeiture of distilled spirits in unstamped casks or packages

This section is identical with section 5639 of the House bill and represents existing law.

Section 5640. Forfeiture of spirits in unstamped containers

This section is identical with section 5640 of the House bill and represents existing law.

Section 5641. Penalty and forfeiture relating to containers of distilled spirits

This section is identical with section 5641 of the House bill and represents existing law.

Section 5642. Penalties for transporting, possessing, etc., distilled spirits in unstamped containers, or counterfeiting of stamps, etc.

This section is identical with section 5642 of the House bill and represents existing law, except for an amendment striking out "5008 (b) (3)" as it appears in the House text and inserting in lieu thereof "5008 (b) (2)".

Section 5643. Penalty and forfeiture for reuse of stamps or bottles, tampering and unlawful removal

This section is identical with section 5643 of the House bill.

The section is a revision of section 2908, Internal Revenue Code (1939), to supply the deficiency in that section, which provided penalties solely with respect to bottled-in-bond spirits and the containers therefor. This revision extends the existing law to all spirits bottled before or subsequent to withdrawal from bond and makes the same penalty applicable to all cases of reuse of stamps or bottles, whether or not the original contents of the bottles were bottled in bond spirits (sec. 2908).

Section 5644. Penalty for counterfeiting bottled-in-bond stamps

This section is identical with section 5644 of the House bill and represents existing law.

Section 5645. Penalty for unlawful affixing, canceling, or issue of stamps by officer

This section is identical with section 5645 of the House bill and represents existing law except that the minimum fine and imprisonment provided by section 2806 (b) (1), Internal Revenue Code (1939), have been omitted.

Section 5646. Penalty for evasion of distilled spirits tax

This section is identical with section 5646 of the House bill and represents existing law.

Section 5647. Penalty and forfeiture for unlawful use or concealment of denatured alcohol

This section is identical with section 5647 of the House bill and represents existing law.

Section 5648. Penalty and forfeiture for fraudulent claims for export drawback or unlawful relanding

This section is identical with section 5648 of the House bill and represents existing law.

Section 5649. Burden of proof in cases of seizure of spirits

This section is identical with section 5649 of the House bill.

The section is identical with present section 2854, Internal Revenue Code (1939), except for the substitution of "internal revenue bonded warehouse or other warehouse authorized by law", for the obsolete designation "distillery warehouse" and "other warehouses for distilled spirits." Also the addition of the words "or records" after the word "books" to conform to modern business practices.

Section 5650. Penalty and forfeiture for operating distillery after giving notice of suspension

This section is identical with section 5650 of the House bill and represents existing law.

Part II—Penalty and Forfeiture Provisions Applicable to Wine and Wine Production

Section 5661. Penalty and forfeiture for violation of laws and regulations relating to wine

This section corresponds to section 5661 of the House bill.

Subsections (a) and (b) are substantially a restatement of the criminal provisions of existing law (sec. 3043), setting up in subsection (a) a felony as to fraudulent offenses and in subsection (b) a misdemeanor as to other offenses.

However, the section is amended to strike out the citation "subpart C of subchapter A" each place it appears in the section and to insert in lieu thereof "subpart C of part I of subchapter A".

Section 5662. Penalty for alteration of wine labels

This section is identical with section 5662 of the House bill.

The section is new and provides punishment for misrepresentation as to the origin or identity of wine, and is designed to fill a loophole in existing law. This is in line with certain of the provisions regarding distilled spirits.

Section 5663. Cross reference

This section is identical with section 5663 of the House bill. This is a cross reference to other penalties applicable to wine that are common to other liquors.

Part III—Penalty, Seizure, and Forfeiture Provisions Applicable to Beer and Brewing

Section 5671. Penalty and forfeiture for evasion of beer tax and fraudulent noncompliance with requirements

This section is identical with section 5671 of the House bill.

The section, derived from section 3159 (a), by increasing the fine to $5,000 and the imprisonment to 5 years, makes a fraudulent violation of the section a felony instead of a misdemeanor, as it is at present.

Section 5672. Penalty for failure of brewer to comply with requirements and to keep records and file returns

This section is identical with section 5672 of the House bill.

The section, derived from section 3159 of the 1939 Code, makes nonfraudulent violation of the section a misdemeanor carrying the same maximum fine or imprisonment, or both.

Section 5673. Forfeiture for flagrant and willful removal of beer without tax payment

This section is identical with section 5673 of the House bill and represents existing law.

Section 5674. Penalty for unlawful removal of beer

This section is identical with section 5674 of the House bill.

The section is substantially the same as section 3159 (c), except that the fine and imprisonment have been increased

Section 5675. Penalty for intentional removal or defacement of brewer's marks and brands

This section is identical with section 5675 of the House bill and represents existing law.

Section 5676. Penalties relating to beer stamps

This section is identical with section 5676 of the House bill.

The section substantially repeats the applicable provisions of present section 3159, with the exception of certain increases in fine and imprisonment.

PART IV—PENALTY, SEIZURE, AND FORFEITURE PROVISIONS COMMON TO LIQUORS

Section 5681. Penalty and forfeiture for failure to post or unlawfully posting signs of distillers, rectifiers or wholesale liquor dealers

This section is identical with section 5681 of the House bill and represents existing law except that the minimum fine and imprisonment provided by section 2831, Internal Revenue Code (1939), have been omitted.

Section 5682. Penalty for breaking locks or gaining access

This section corresponds to section 5682 of the House bill except that the words "otherwise than" have been inserted before the phrase "as authorized by law" to preserve the obvious intent of the section.

The section is derived from section 2821 of existing law. It has been broadened and extended generally to apply to the breaking of all seals and locks affixed by duly authorized officers of the revenue, and the minimum fine and term of imprisonment has been eliminated. The phrase "otherwise than as authorized by law" is intended to cover authorization by regulations and would impose a penalty for destroying, breaking, injuring, or tampering with any lock or seal without lawful authorization. This will permit the Secretary or his delegate to prescribe, by regulations, the conditions under which the penalty will not be incurred. The Secretary or his delegate may, by regulations, prescribe the lawful conditions under which such action may be taken in the absence of a proper officer. Thus, a proprietor, in order to preserve his property or to protect the lives of his employees, could be authorized under conditions prescribed by regulations to break any lock or seal which would need be broken, without incurring the penalty.

Section 5683. Penalty and forfeiture for removal of liquors or wines under improper brands

This section is identical with section 5683 of the House bill and represents existing law.

Section 5684. Penalties relating to the payment and collection of liquor taxes

This section is identical with section 5684 of the House bill and represents existing law.

Section 5685. Penalty and forfeiture relating to possession of devices for emitting gas, smoke, etc., explosives and firearms, when violating liquor laws

This section is identical with section 5685 of the House bill and represents existing law.

Section 5686. Miscellaneous penalties

This section is identical with section 5686 of the House bill.

Subsection (a) of this section effectively contains the provisions of present section 3115, except the fine and imprisonment have been brought in line with others throughout the chapter.

Subsection (b) of this section is a statement of the substance in present section 3116, so stated as to apply to violations of this chapter.

Subsection (c) is merely cross reference to section 7302, which contains the seizure and forcfeiture provisions appearing in present section 3116.

Section 5687. Penalties and forfeitures applicable to distillers, rectifiers and wholesale liquor dealers for offenses not specifically covered

This section is identical with section 5687 of the House bill and represents existing law.

Section 5688. Disposition and release of seized property

This section is identical with section 5688 of the House bill.

Subsections (a) and (b) are a restatement of the provisions now appearing in section 2805 (a) (b), except that, pursuant to 63 Statutes 377, et seq., the Administrator of General Services now performs the duties and functions that were performed by the Secretary under subsection (a) (1) (2) (3) (4) of said section 2805, in regard to delivery and disposal of forfeited liquors, and the issuance of regulations pertaining thereto.

Subsection (c) is merely a restatement of present section 3173(d).

Subsection (d) is derived from section 3118, with emphasis in the present text that the provisions apply only to industrial alcohol operations.

Section 5689. Penalty and forfeiture for tampering with a stamp machine

This section is identical with section 5689 of the House bill.

The section merely retains and consolidates the provisions of sections 2800 (a) (B), 3112 (b), and 3150 (b) (3). It has, however, been broadened to include wine in accordance with section 5061 (b).

Section 5690. Definition of the term "person"

This section is identical with section 5690 of the House bill.

This definition is identical with that in section 3173 (b) (4). This provision follows the general provisions set forth in section 7343.

Part V—Penalties and Forfeitures Applicable to Occupational Taxes

Section 5691. Penalties and forfeitures for nonpayment of special taxes relating to liquors

This section is identical with section 5691 of the House bill, and represents existing law except that the minimum fine and imprisonment provided by section 3253, Internal Revenue Code (1939), have been omitted.

Section 5692. Penalty relating to records of retail liquor dealers

This section is identical with section 5692 of the House bill and represents existing law.

Section 5693. Penalties relating to posting of special tax stamps

This section is identical with section 5693 of the House bill. This section is merely a cross reference to section 7273 (a) relative to penalty for failure to post special tax stamps.

Chapter 52—Tobacco, Cigars, Cigarettes, and Cigarette Papers and Tubes

SUBCHAPTER A—DEFINITIONS; RATE AND PAYMENT OF TAX; EXEMPTION FROM TAX; REFUND AND DRAWBACK OF TAX

Section 5701. Rate of tax

This section is substantially the same as section 5701 of the House bill except that the date "April 1, 1954" appearing in subsection (c), relating to the reduction in tax on small cigarettes, has been changed to "April 1, 1955" in conformity with section 601 (a) (7) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954).

The section is the same, in substance, as the provisions of existing law, except that all reference to sale or removal of the taxable articles has been omitted since section 5703 provides for determination of tax at the time of removal and since it is desirable to make certain that the tax attaches at the time of manufacture or importation of the articles to conform to the intent of the present law and to court decisions. The section has been further simplified by the omission of all material tending to define the articles on which tax is imposed, since appropriate definitions thereof are set forth in section 5702. The existing exemption with respect to cigarette papers and tubes sold to a manufacturer of cigarettes has been omitted, since transfers in bond of cigarette papers and tubes to a manufacturer of cigarettes are now made expressly exempt from tax under section 5704. Its retention in the taxing section would merely be repetitive. A provision, similar to that in existing law with respect to the size of cigarettes for tax purposes, has been added to this section with respect to cigarette papers and tubes in order to spell out the size of such articles for tax purposes, and to block any attempt to taxpay long cigarette papers and tubes as single units and evade tax.

Section 5702. Definitions

In this section, which is identical with section 5702 of the House bill, are assembled several definitions now set forth in different sections of the existing law to which additional definitions have been added.

The definition of "manufactured tobacco" has been expanded to include snuff and snuff flour and the specific provisions with respect to these products have been eliminated, since the same tax rates have been imposed on manufactured tobacco and snuff for many years, and since snuff is merely another form of tobacco used in the mouth or nose. It has been further expanded to include any tobacco not exempt from tax under this chapter, sold or delivered contrary to the provisions of this chapter and regulations issued pursuant thereto, comparable to the provisions of section 2100 (c) (2) of the present code.

The reference to substitute for tobacco in the definition of cigars and cigarettes in existing law (secs. 2000 and 2110) has been eliminated because it has proved in practice to be meaningless since it would only apply to a substance which so closely resembles tobacco in characteristics and effects as to take its place.

The definition of "manufacturer of tobacco" in existing law is expanded so as to include not only persons who manufacture tobacco, but also persons who package tobacco for use in the mouth or nose, and who sell or deliver tobacco not exempt from tax contrary to law and regulations. Excluded are farmers and growers of tobacco, and cooperative associations, who sell leaf tobacco grown by themselves or by their members, provided the tobacco so sold is in the condition as cured on the farm (the test for exemption under existing law) and dealers in tobacco materials who handle tobacco solely for sale, shipment, or delivery in bulk to other dealers, manufacturers, or for export.

The definition of "manufacturer of cigars and cigarettes" is the same, in substance, as that in existing law (sec. 2030). The definition in this section spells out the fact that a person who manufactures cigars or cigarettes solely for his own personal consumption is not a manufacturer of such articles.

The definition of "dealer in tobacco materials" represents a broadening of the definition of "dealer in leaf tobacco" in existing law (sec. 2050) so as to permit such a dealer to handle all tobacco materials, whereas his activities are presently restricted by law to leaf tobacco. This definition, therefore, includes dealers in other kinds of tobacco materials who are presently regarded as "quasi" manufacturers of tobacco since they do not produce a taxable product.

The definition of "removal" or "remove" controls the time at which the tax is determined and is intended to be flexible so that the Secretary or his delegate may, by regulation, permit determination of tax upon removal of the articles from bond, under a return tax payment system, instead of upon removal from the premises of the bonded factory where produced as required by existing law. For purposes of certainty and clarification this definition also includes removal of articles from customs custody and the smuggling or other unlawful importation of such articles.

The definition of "importer" is intended to give precise meaning to the term and to include any person who smuggles or otherwise brings nontaxpaid articles into the United States.

Similarly, to give precise meanings to other expressions frequently used in the chapter, definitions have been provided for "tobacco products," "cigarette paper," "cigarette tube," "manufacturer of cigarette papers and tubes," and "articles," and "tobacco materials."

Section 5703. Liability for tax and method of payment

This section is substantially in the form in which it passed the House except that your committee has eliminated as unnecessary the provision that the tax shall continue to be paid by stamp until January 1, 1955, in view of the fact that this section of the bill will not become effective until January 1, 1955. As amended by your committee, the tax will continue to be paid by stamp until the Secretary or his delegate provides by regulation for the payment of the tax by return.

Subsection (b) "Stamps to Evidence the Tax", as it passed the House, provided that such stamps would be issued for sale at a sum sufficient to defray the cost of preparation. This subsection has been amended by your committee so as to eliminate this requirement and to provide in lieu thereof that such stamps shall be issued, used and accounted for in accordance with regulations prescribed by the Secretary or his delegate.

In view of this amendment, stamps to evidence the tax, if required, will be furnished to the taxpayer without charge and there is, therefore, no reason for providing for their redemption. Accordingly, section 5708 of the House bill, which provided for the redemption of these stamps, has become unnecessary and your committee has eliminated it in its entirety.

Section 5703 contemplates a major change in existing law since it includes, as indicated above, a provision which would enable the Secretary or his delegate, by regulation, to substitute a system for payment of tax by return, in lieu of the present system of prepayment of the tax by the purchase and affixture of stamps prior to removal of the articles.

Authority is provided in this section for the Secretary or his delegate to prescribe stamps to evidence the tax under a system involving payment of tax by return as distinguished from the present stamps to denote tax payment.

Provision is made for the Secretary or his delegate to authorize Federal Reserve banks and other depositaries or financial agents of the United States to receive payments of taxes imposed by this chapter, if made payable by return.

The provision for assessment of taxes, which are not paid at the time required, has been restated in substantially the same language as set forth in existing law (sec. 2002 (b)).

Section 5704. Exemption from tax

This section is identical with section 5704 of the bill as passed by the House.

The several exemptions from tax set forth in separate sections of existing law are assembled in this section to which have been added several new exemptions.

The existing exemption from tax with respect to cigars and cigarettes used by employees for personal consumption and for experimental purposes has been extended to include manufactured tobacco as a matter of equity. However, the present limitation of 21 cigars or cigarettes per employee per week in existing law (sec. 2111 (f)) has been eliminated as a matter of detail which should be more properly covered by regulations so as to permit of flexibility.

A new exemption is included in this section which would permit manufacturers to transfer articles in bond, without payment of tax, between bonded factories, as provided by regulation. This exemption is administratively desirable to permit different manufacturers and different factories to perform steps in the production of the finished product prior to tax payment. This provision continues the existing exemption from tax (sec. 2000 (d)) as to cigarette papers and tubes sold to a manufacturer of cigarettes for use by him in the manufacture of cigarettes.

The existing exemption from tax on articles shipped for export (sec. 2135 (a) (1) and (3)) has been restated in substantially the same form in this section.

The existing exemption from tax on articles removed for consumption beyond the jurisdiction of the internal revenue laws of the United States (sec. 2197 (b)) has been restated in substantially the same form in this section.

The existing exemption from tax on articles withdrawn for the use of the United States (sec. 3331) has been restated in substantially the same form in this section.

This section also provides for exemption from tax on all tobacco materials shipped by a dealer in tobacco materials or a manufacturer of articles to another such dealer or manufacturer, or for export. This section extends to dealers in tobacco materials the same authority afforded to manufacturers of articles and dealers in leaf tobacco by existing law (secs. 2059, 2135 (a) (2), and 2101) to ship tobacco materials to manufacturers, dealers, and for export.

The section provides a new exemption under which arlicles and tobacco materials may be released from customs custody, without payment of tax, for delivery under bond to the bonded premises of a manufacturer. This exemption will eliminate the present illogical situation requiring payment of the internal revenue tax prior to the release of the articles from customs custody, which tax is subsequently refunded by redemption of the tax stamps, under authority of existing law (sec. 2198), when the articles are delivered to the bonded premises of a manufacturer.

Section 5705. Refund or allowance of tax

This section is identical with section 5705 of the House bill.

It will afford refund relief comparable to that now embodied in existing law (secs. 2198, 3304, and 3313). In addition, the tax may be refunded or credit allowed when articles are lost, but not stolen, or are destroyed by fire, casualty, or act of God, while in the possession, control, or ownership of the manufacturer or importer. The standard period of 3 years for the filing of claims is prescribed.

Section 5706. Drawback of tax

This section is identical with section 5706 of the House bill.

It retains those provisions of existing law (sec. 2136) necessary to prescribe the standard giving rise to benefit of drawback, but leaves the details to be prescribed by regulation.

Section 5707. Floor stocks refund on cigarettes

This section is substantially in the form in which it passed the House except that the dates "April 1, 1954" and "July 1, 1954" appearing in subsection (a) "In General", and the date "April 1, 1954" appearing in subsection (b) "Limitations on Eligibility for Credit or Refund" have been amended to "April 1, 1955" and "July 1, 1955" in conformity with section 601 (b) (3) of the Excise Tax Reduction Act of 1954 (Public Law 324, 83d Cong., 2d sess., approved March 31, 1954).

The section is identical with existing law (sec. 2000 (g)) except for the elimination of the requirement of proof of sales reflecting the tax reduction, which provision is not feasible of administration.

Section 5708. Redemption of stamps

This section of the House bill has been deleted by your committee as unnecessary in view of the amendment by your committee of section 5703 of the House bill to eliminate the provisions for the sale of stamps provided for in section 5703 (b). Since there will be no charge for these stamps, it is not necessary to provide for their redemption.

SUBCHAPTER B—QUALIFICATION REQUIREMENTS FOR MANUFACTURERS OF ARTICLES AND DEALERS IN TOBACCO MATERIALS

Section 5711. Bond

This section is identical with section 5711 of the House bill.

The section consolidates the several separate requirements of existing law (secs. 2013, 2033, 2039 (a), and 2053) for manufacturers of articles and dealers in tobacco materials to give bond. There are provided, in this section, uniform requirements for manufacturers of articles and dealers in tobacco materials to give bond, conditioned upon compliance with the provisions of this chapter and regulations issued thereunder. The form, amount, and other such details set forth in existing law are to be prescribed by regulation. The section provides that the bond may be disapproved if the Secretary or his delegate determines that the bond is not adequate to protect the revenue, and that it may be canceled if he determines that the bond no longer adequately protects the revenue. These provisions are required for effective administration of the law and protection of the revenue.

Section 5712. Application for permit

This section is identical with section 5712 of the House bill.

It replaces the several separate provisions of existing law (secs. 2011, 2012, 2031, 2032, 2051, and 2052) which provide that manufacturers of articles and dealers in leaf tobacco register and furnish statements before commencing such businesses. In lieu thereof, this section provides for the making of an application for a permit. For effective administration of the law and protection of the revenue, authority is provided for the Secretary or his delegate to reject the application and deny the permit if he finds that (1) the premises are not adequate to protect the revenue, or (2) the applicant is not likely to maintain operations in compliance with the provisions of this chapter of the code, or has failed to disclose material information required, or has made a material false statement in the application.

There is a saving provision that no person engaged in business as a manufacturer of articles or dealer in tobacco materials on the effective date of this chapter shall be denied the right to carry on such business pending a reasonable opportunity to make application for such permit and final action thereon.

Section 5713. Permit

This section is identical with section 5713 of the House bill.

The section, which replaces those sections of existing law with respect to certificates (secs. 2014 and 2054), provides for the issuance, suspension, and revocation of permits to engage in business as a manufacturer of articles or as a dealer in tobacco materials. These provisions are considered necessary for the effective administration of the law and protection of the revenue.

SUBCHAPTER C—OPERATIONS BY MANUFACTURERS OF ARTICLES

Section 5721. Inventories

This section is identical with section 5721 of the House bill.

It continues the present requirement for inventories by manufacturers of articles at the time of commencing and concluding business (secs. 2017 and 2036), but leaves to the regulations much of the procedure and detail with respect to such inventories. This section would discontinue the existing statutory requirement that manufacturers of articles make inventories on January 1 of each year. However, manufacturers would be required to make an inventory, in addition to that required at the time of commencing and concluding business, as prescribed by regulations for enforcement purposes and protection of the revenue.

Section 5722. Reports

This section is identical with section 5722 of the House bill.

It is derived from existing law (secs. 2019, 2038, 2039 (b), and 2194), which sets forth the requirements for reports and spells out, in considerable detail, the items to be included therein. This section, applicable only to manufacturers of articles, leaves to regulations the information to be reported, the form of the report, the time for filing, and the period to be covered by the report.

Section 5723. Packages, labels, notices, and stamps

This section is identical with section 5723 of the House bill.

It is derived from existing law (secs. 2100, 2111, and 2130), which prescribes the exact sizes of packages in which tobacco, snuff, cigars, and cigarettes may be put up for domestic sale or consumption, and spells out the language of the notices and labels required by existing law to be affixed to such packages. Subsection (a) of this section provides that all articles shall, before removal, be put up in packages having such labels, notices, and stamps as the Secretary or his delegate shall by regulations prescribe. This subsection places no restriction on the sizes of packages in which such articles may be put up. The labels, notices, and stamps which the Secretary or his delegate may require by this subsection are such labels, notices, and stamps as may be necessary for the protection of the revenue. It is not intended by this subsection to authorize the regulation of customary package labels and wrappers. While sizes of packages are no longer prescribed, such articles are required to be put up in packages before removal with the specifications for such packages to be prescribed by regulations.

The provisions of existing law (secs. 2100 (d) and 2111 (c)), relating to the prohibited enclosure of lottery features or immoral or indecent material, have been restated in subsections (b) and (c).

Subsection (d) restates those exemptions from packing requirements provided in existing law (secs. 2100 (c) (1), 2111 (a) (3), (e) (2) and (f)) for tobacco, snuff, cigars, and cigarettes exported, and for cigars and cigarettes used for consumption by employees or for experimental purposes.

SUBCHAPTER D—OPERATIONS BY DEALERS IN TOBACCO MATERIALS

Section 5731. Shipments and deliveries restricted

This section is identical with section 5731 of the House bill.

It enables the Secretary or his delegate, by regulation, to restrict the shipment and delivery of tobacco materials by dealers similar to existing law (secs. 2059 and 2060) and imposes a tax on such materials shipped or delivered in violation of the regulations prescribed thereunder.

Section 5732. Statement of shipments and deliveries

This section is identical with section 5732 of the House bill and constitutes a restatement of existing law (sec. 2058).

SUBCHAPTER E—RECORDS OF MANUFACTURERS OF ARTICLES AND DEALERS IN TOBACCO MATERIALS

Section 5741. Records to be maintained

This section is identical with section 5741 of the House bill.

The section consolidates the provisions in existing law (secs. 2018, 2037, 2039 (b), 2056, and 2194) which set forth separately the requirements for records to be maintained and spell out, in considerable detail, the items to be entered. This section, in the interest of flexibility, leaves to regulation those details presently set forth by law.

SUBCHAPTER F—GENERAL PROVISIONS

Section 5751. Purchase, receipt, possession, or sale of articles, after removal, not exempt from tax

This section is identical with section 5751 in the House bill. It consolidates the provisions of existing law (secs. 2104 (a), 2113, and 2170 (a) (2)) which prescribe similar restrictions with regard to tobacco, snuff, cigars and cigarettes, and contains a new provision that any person who possesses articles not exempt from tax, after removal, not put up in packages bearing the labels, notices, or stamps prescribed, shall incur liability to the tax in addition to any penalties prescribed. This new provision will permit collection of the tax on articles removed for a tax-exempt purpose but diverted to a taxable use.

Section 5752. Restrictions relating to used labels, stamps, and packages

This section is identical with section 5752 of the bill as passed by the House.

It consolidates existing law (secs. 2103 (e) and 2112 (c)) which sets forth separately the requirements for destruction of tax stamps on emptied packages. This section would continue this requirement with respect to such tax stamps, and would also require destruction of any label or other stamp, affixed to a package to evidence tax, when the package is emptied. It also prohibits any trafficking in such labels or stamps and in emptied packages bearing such labels or stamps.

Section 5753. Disposal of forfeited, condemned, and abandoned articles and tobacco materials

This section is identical with section 5753 of the House bill and restates the provisions of existing law (sec. 2190) except that the manner of disposition of forfeited, condemned, and abandoned articles and tobacco materials, which will not bring a price equal to the tax due and payable thereon, is omitted and left to regulations.

SUBCHAPTER G—FINES, PENALTIES, AND FORFEITURES

Section 5761. Civil penalties

This section is identical with section 5761 of the bill as passed by the House.

There are assembled in this section those civil penalties now provided in existing law (secs. 2161 (m) (1) and 2156 (c)), and a new civil penalty to apply where the tax is not paid at the time prescribed, regardless of whether the failure to pay on time is willful or deliberate. Under the present system of prepayment of tax by stamps no such provision is necessary. However, adequate administration of a system of tax payment by return implies the timely payment of taxes when due, and the imposition of penalties to cover a failure to pay even in nonwillful cases is, therefore, an appropriate enforcement measure.

Section 5762. Criminal penalties

This section is identical with section 5762 in the bill as passed by the House.

It sets forth clearly those violations which are to be punishable as felonies and provides that other offenses shall be punishable as misdemeanors, specifying that any violation of this chapter, or of regulations prescribed thereunder, which is not specifically defined as a felony, shall be punishable as a misdemeanor. The section eliminates the many inequities and inconsistencies in the multitude of specific penalties prescribed in existing law (secs. 2150 through 2180) and treats like violations in a like manner.

Section 5763. Forfeitures

This section is identical with section 5763 of the House bill and is largely a restatement of existing law.

In separate sections of existing law, there are many provisions for forfeiture of property of various types held or owned applicable to tobacco and snuff, cigars and cigarettes, and leaf tobacco. These various and separate provisions have been assembled, in this section, into four subsections which deal with articles unlawfully possessed, personal property of qualified manufacturers and dealers with intent to defraud, real and personal property of illicit operators, and a general provision referring to section 7302 in the general provisions of the code.

Chapter 53—Machine Guns and Certain Other Firearms

SUBCHAPTER A—TAXES

Part I—Special (Occupational) Taxes

Section 5801. Tax

This section is identical with section 5801 of the House bill and changes section 3260, Internal Revenue Code (1939) in the following respects:

(1) In the proviso of subsection (a) of present section 3260, the words "two attached" are used before the word "barrels." In the proposed new text these words are deleted and the words "combination shotgun and rifle" are used in place thereof. This change is explained as follows: Bill H. R. 9610, known as Public No. 651, 75th Congress, was approved June 16, 1938, to afford, inter alia, relief to manufacturers and dealers from the high rates of special taxes then imposed upon a sporting type of firearm having two attached barrels, which was not a type of firearm used by gangsters or criminals. That bill reduced the special tax on manufacturers of such firearms from $500 to $25 per year and also reduced the dealer's tax from $200 to $1. Apparently at the time the aforesaid bill was enacted into law it was not observed that the language used would also similarily reduce the special taxes on the gangster-type gun, namely, the double-barrel shotgun with barrels less than 18 inches in length. Because the double-barrel sawed-off shotgun is a more potent weapon than the single-barrel sawed-off shotgun it is felt that this undesirable situation should be rectified. Also, the proposed new wording would continue to give the desired relief to manufacturers of and dealers in the sporting-type firearm which the original bill H. R. 9610 granted.

(2) In the proviso of subsection (a) of present section 3260, the phrase "12 inches or more in length" is used. In the proposed new text an addition is made to that phrase by adding the words "but less than 18 inches" following the word "more." This change is desirable in that the existing text of the law results in the interpretation by many persons that the statute covers manufacturers and dealers in sporting-type rifles and shotguns with barrels of 18 or more inches in length even though in the basic definition of a firearm as given in present section 2733 (a) (sec. 5848 (a) new text) it is provided, among other things, that only shotguns or rifles having barrels less than 18 inches in length are to be considered firearms.

(3) A subsection (c) has been added merely for cross-reference purposes as so indicated by its title.

Section 5802. Registration

This section is identical with section 5802 of the House bill and represents existing law.

Section 5803. Exemptions

This section is identical with section 5803 of the House bill and represents existing law.

Part II—Transfer Tax

Section 5811. Tax

This section is identical with section 5811 of the House bill and changes section 2720, Internal Revenue Code, in the following respects:

(1) In the proviso of subsection (a) of present section 2720, the words "two attached" are used before the word "barrels." It is proposed in the new text that these words be deleted and the words "combination shotgun and rifle" be used in place thereof. This change is explained as follows: Bill H. R. 9610, known as Public, No. 651, 75th Congress, was approved June 16, 1938, to afford, inter alia, relief from the high transfer tax then imposed upon a sporting type firearm having two attached barrels, which was not a type of firearm used by gangsters or criminals. That bill reduced the transfer tax from $200 to $1. Apparently at the time the aforesaid bill was enacted into law it was not observed that the language used would reduce the transfer tax on the gangster-type gun, namely the double-barrel shotgun with barrels less than 18 inches in length, from $200 to $1. The language used developed a further inequity in the transfer tax on firearms, in that a single-barrel sawed-off shotgun with a barrel of 15 inches in length would be subject to a $200 transfer tax whereas a shotgun of identical manufacture but with double-barrels, 15 inches in length, could be transferred by the payment of a $1 transfer tax. Because the double-barrel sawed-off shotgun is a more potent weapon than the single-barrel sawed-off shotgun it is felt that this generally undesirable situation should be rectified. Also, the new wording would continue to give the desired relief to transferors of sporting-type firearms which the original bill, H. R. 9610, granted.

(2) In the proviso of subsection (a) of present section 2720, the phrase "12 inches or more in length" is used. In the proposed new text an addition is made to that phrase by adding the words "but less than 18 inches" following the word "more." This change is desirable in that the existing text of the law results in the interpretation by many persons that the transfer taxes are imposed upon sporting-type rifles and shotguns with barrels of 18 or more inches in length even though in the basic definition of a firearm, as given in the present section 2733 (a) (sec. 5848 (a) new text), it is provided, among other things, that only shotguns or rifles having barrels less than 18 inches in length are to be considered firearms. For this reason statutory limitation is proposed to be specified for the maximum barrel length of firearms.

(3) The cross reference under section 2720 (c) (2) of the existing law and the registration and special tax reference under section 2720 (d) of the existing law have been incorporated in the new text under a new subparagraph (d) entitled "Cross Reference."

Section 5812. Exemptions

This section is identical with section 5812 of the House bill, and the same as section 2721, Internal Revenue Code (1939), except that in the caption of subsection (c) of the new text the words "Exemption From" have been added.

Section 5813. Stamps

This section is identical with section 5813 of the House bill and represents existing law.

Section 5814. Order forms

This section is identical with section 5814 of the House bill and represents existing law.

Part III—Tax on Making Firearms

Section 5821. Rate, exceptions, etc.

This section is identical with section 5821 of the House bill and represents existing law.

Part IV—Other Taxes

Section 5831. Cross references

This section is identical with section 5831 of the House bill and is primarily a codifier's reference.

SUBCHAPTER B—GENERAL PROVISIONS

Section 5841. Registration of persons in general

This section is identical with section 5841 of the House bill and changes section 3261 (b), Internal Revenue Code (1939), in the following respect:

The words "of the district in which he resides" following the word "collector" in present section 3261 (b), have been deleted so as to abolish an unnecessary step in the registration of firearms. This is explained as follows: From the inception of the National Firearms Act (now incorporated in the Internal Revenue Code) firearms registrations have been kept in a central file of the National Office of the Internal Revenue Service in Washington, D. C., rather than in a file in each district. Under existing procedure the district directors of internal revenue have had to handle the registrations because they are required to do so by the present law, although their handling of the registration forms serves no useful purpose. Moreover, experience has shown that a central file is desirable because of the necessity of determining whether or not a firearm has been registered, and also because such file furnishes one central source of information for use in court actions.

Section 5842. Books, records and returns

This section is identical with section 5842 of the House bill and represents existing law.

Section 5843. Identification of firearms

This section is identical with section 5843 of the House bill and represents existing law.

Section 5844. Exportation

This section is identical with section 5844 of the House bill and represents existing law.

Section 5845. Importation

This section is identical with section 5845 of the House bill and represents existing law.

Section 5846. Other laws applicable

This section is identical with section 5846 of the House bill and represents existing law.

Section 5847. Regulations

This section is identical with section 5847 of the House bill and represents existing law.

Section 5848. Definitions

This section is identical with section 5848 of the House bill and changes section 2733, Internal Revenue Code, in the following respects:

The section is identical with present section 2733, except that three new provisions have been added which define "rifle," "shotgun," and "any other weapon." These new definitions are needed for the reason that Congress did not define such weapons when the National Firearms Act was enacted in 1934 although it did define "machine gun." Since Congress did not define these weapons it has been necessary to use the ordinarily accepted definitions thereof appearing in acceptable, standard dictionaries. In so doing, and because of a technical application of the definition of the term "firearm," as it appears in the present statute, many weapons firing projectiles by the action of an explosive have been brought within the scope of the National Firearms Act although it is believed the Congress did not intend that such weapons should be included. For example, under a technical interpretation of the term "firearm," blunderbusses, muzzle-loading shotguns, and other ancient or antique guns have been considered subject to the National Firearms Act and in many instances the requirements thereof have been imposed. As a result of these interpretations, over a period of years, restrictions have been imposed on a certain class of persons, namely, antique gun collectors, and it is felt that these restrictions should be removed in pursuance of the clearly indicated congressional intent to cover under the National Firearms Act only such modern and lethal weapons, except pistols and revolvers, as could be used readily and efficiently by criminals or gangsters. Moreover, for proper administration of the National Firearms Act it is considered highly proper and desirable that the Congress define the terms "rifle," "shotgun," and "any other weapon" so as to remove any doubt as to the type of firearms which Congress intended to bring within the scope of the National Firearms Act.

SUBCHAPTER C—UNLAWFUL ACTS

Section 5851. Possessing firearms unlawfully transferred or made

This section is identical with section 5851 of the House bill and represents existing law.

Section 5852. Removing or changing identification marks

This section is identical with section 5852 of the House bill and represents existing law.

Section 5853. Importing firearms illegally

This section is identical with section 5853 of the House bill and represents existing law.

Section 5854. In case of failure to register and pay special tax

This section is identical with section 5854 of the House bill and represents existing law.

SUBCHAPTER D—PENALTIES AND FORFEITURES

Section 5861. Penalties

This section is identical with section 5861 of the House bill and represents existing law.

Section 5862. Forfeitures

This section corresponds to section 5862 of the House bill, except that subsection (a) thereof is amended by deleting the words "Any firearm which has at any time been transferred or made in violation of the provisions of this chapter" and by substituting in lieu thereof the words "Any firearm involved in any violation of the provisions of this chapter or any regulation promulgated thereunder".

The noted amendment will make the forfeiture provisions of this chapter conform to and be coextensive with the corresponding provisions of the Federal Firearms Act (15 U. S. C. 905 (b)), which deals with the transfer of similar gangster weapons in interstate commerce. The amendment will eliminate present administrative difficulties in the disposition of gangster type weapons used in violation of this chapter but not now forfeitable under the provisions of section 5862 (a) of the House bill.

SUBTITLE F—PROCEDURE AND ADMINISTRATION

CHAPTER 61—INFORMATION AND RETURNS

Section 6001. Notice or regulations requiring records, statements, and special returns

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6011. General requirement of return, statement, or list

This section, which corresponds to that of the House bill, contains no material change from existing law. Your committee has added a new subsection to preserve the specific requirement of existing law with respect to the identification of taxpayers for social security and income tax withholding purposes.

Section 6012. Persons required to make returns of income

This section corresponds to that of the House bill except for a clerical change combining paragraphs (4) and (5) of subsection (a).

Subsection (a) (1) of this section differs from existing law in that it provides that any taxpayer who has attained the age of 65 before the close of his taxable year shall be required to make a return only if he has for the taxable year a gross income of $1,200 or more. As under existing law, all other individuals are required to file income-tax returns if they have gross income of $600 or more for the taxable year.

Subsection (a) (4) of this section, by use of the term "taxable income," conforms the filing requirement for trusts to the new exemption of $300 granted certain trusts under subtitle A. A clarifying change from the wording of existing law has been made in subsection (b) (3), relating to the filing of corporation returns by receivers or other fiduciaries.

Section 6013. Joint returns of income tax by husband and wife

This section corresponds to that of the House bill, except for a clerical change, the redesignation of subsection (a) (4) as subsection (d), and the addition of a new subsection (c).

There is a substantive change in subsection (b) (2) (A) of this section. Under present law a joint return may not be filed after separate returns are filed unless all the tax shown on the separate returns, plus any other amounts assessed or any deficiency asserted with respect to such returns, is paid in full. This section permits a joint return to be filed after separate returns have been filed if the total tax shown on the joint return is paid.

Subsection (c) is designed to remove the problems which would result, for example, from the application of the 1939 Code to the income of one spouse and the 1954 Code to the income of the other spouse where one spouse dies during 1954 before the enactment of this code and a joint return is subsequently filed for the calendar year 1954.

Section 6014. Income tax return—Tax not computed by taxpayer

This section is the same as that of the House bill except for a conforming amendment.

If the taxpayer files Form 1040A, he does not compute the tax but the Internal Revenue Service computes the tax and sends the taxpayer notice of the amount payable. This section provides that in determining such amount the credit against tax for dividends received, provided by section 34, or the credit for retirement income, provided by section 37, shall not be allowed. Such taxpayer, however, receives the benefit of the partial exclusion of dividends from gross income provided by section 116.

Section 6015. Declaration of estimated income tax by individuals

This section corresponds to that of the House bill except for two substantive changes and several clerical or technical changes. One substantive change made by your committee extends the date in subsection (f) for filing an income tax return in lieu of a final declaration of estimated tax from January 15 to January 31. If an income tax return is not filed on or before January 31, the last date for filing a declaration or an amended declaration is January 15. Also, instead of the credits under sections 31 and 32 as provided in the House bill, your committee has made a change in paragraph (2) of subsection (f), the effect of which is to include all credits under part IV of subchapter A of chapter 1.

Your committee has added a new subsection making this section applicable only with respect to taxable years beginning after December 31, 1954. The pertinent sections of the 1939 Code shall continue in full force and effect with respect to taxable years beginning before January 1, 1955.

Under existing law, individuals whose incomes are primarily from wages or salaries are required to file declarations if their income is expected to be more than $4,500 plus $600 for each exemption. For individuals with over $100 of income from other sources, declarations must be filed if their gross income is expected to exceed $600. Section 6015 provides that, for an individual with no more than $100 of gross income from sources other than wages or salaries, a declaration is required if his gross income is expected to be more than $5,000; however, no declaration is required by a married person if the gross income of the married person and his spouse is expected to be not more than $10,000, nor from a head of a household (as defined in sec. 2 (b)) if his gross income is expected to be not more than $10,000. For an individual with more than $100 of income not subject to withholding, a declaration is required if his gross income from all sources is expected to be more than $600 per exemption plus $400.

Section 6015 also provides that February 15 is the final date on which a farmer may file a tax return in lieu of a declaration for the year. Under existing law the final date is January 31.

For a discussion of the other features of the estimated tax payable by individuals, see the explanation under sections 6073, 6153, and 6654 of this report.

Section 6016. Declarations of estimated income tax by corporations

This section corresponds to that of the House bill, except that your committee has changed the filing requirement for declarations of estimated tax by corporations from a tax liability in excess of $50,000 to a tax liability in excess of $100,000.

This section contains the filing requirements relating to a new system for advance payments of corporation income tax. Only corporations subject to taxation under section 11 or 1201, or subchapter L of chapter 1, whose tax liability for the taxable year can reasonably be expected to exceed $100,000 ($50,000 under the House bill) are required to file declarations. The tax to be so estimated and declared is the income tax for the taxable year computed after deducting the estimated credits against tax allowable to the corporation and after deducting the $100,000 exemption.

For a discussion of the other features of the estimated tax payable by corporations, see the explanation under sections 6074, 6154, and 6655 of this report.

Section 6017. Self-employment tax returns

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6018. Estate tax returns

This section, which is identical with that of the House bill, contains no material change from existing law, except that the requirement that a duplicate copy of the return be filed has been eliminated.

Section 6019. Gift tax returns

This section, except for a minor clerical amendment, corresponds to that of the House bill. This section contains no material change from existing law.

Section 6020. Returns prepared for or executed by Secretary

This section, which corresponds to that of the House bill, contains no material change from existing law. In your committee's bill subsection (b) (1) has also been made inapplicable to declarations of estimated tax by corporations. Your committee has also made a clerical amendment in subsection (b) (2) so as to restore existing law.

Section 6021. Listing by Secretary of taxable objects owned by nonresidents of internal revenue districts

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6031. Return of partnership income

This section, which corresponds to that of the House bill, contains no material change from existing law. For the purpose of clarification, your committee has inserted a parenthetical reference to section 761 (a), which defines the term "partnership", and the words "taxable income" are used instead of "net income."

Section 6032. Returns of banks with respect to common trust funds

This section, which corresponds to that of the House bill, contains no material change from existing law. Your committee has made a technical amendment which substitutes "taxable income" for "net income."

Section 6033. Returns by exempt organizations

This section corresponds to that of the House bill except for several minor technical changes and a substantive change. The substantive change made by your committee would relieve the pension and profit-sharing trusts described in section 401 (a) of the committee bill from stating in their returns any information which is reported in the returns of employers establishing such trusts. The granting of this relief is to be in the discretion of the Secretary or his delegate.

Section 6034. Returns by trusts claiming charitable deductions under section 642 (c)

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6035. Returns of officers, directors, and shareholders of foreign personal holding companies

This section, which corresponds to that of the House bill, contains no material change from existing law. Your committee has made a technical amendment which substitutes "taxable income" for "net income."

Section 6036. Notice of qualification as executor or receiver

This section corresponds to that of the House bill except for a change which restricts the term "assignee" to "assignee for benefit of creditors".

The present estate-tax law requires every executor after qualifying as such to give the Internal Revenue Service notice thereof. Trustees in bankruptcy, receivers, and other persons similarly situated are also required by this section to give notice of the proceedings. Since such notice is necessary only where matters affecting the revenue are involved, this section authorizes the Secretary by regulations to relieve from this requirement any executor or any other person otherwise required to file a notice. It is contemplated that no second notice will be required in cases where the trustee in bankruptcy or the court is now required under the Bankruptcy Act to notify the Secretary of such proceedings.

Section 6037. Cross references

This section is identical with that of the House bill.

The cross references contained in this section are to specific provisions of law relating to notices, exemption certificates, receipts, statements, etc.

Section 6041. Information at source

This section corresponds to section 6041 of the House bill except that your committee has made a substantive change which restores the provisions of section 147 (a) of existing law to the extent of requiring information returns from persons engaged in a trade or business with respect to payments made in the course of such trade or business.

This section continues in effect the provisions of section 147 (b) of existing law with respect to information returns by persons in the business of collecting (or who collect for profit) foreign items.

As under the House bill this section also continues in effect the provisions of section 147 (b) of existing law with respect to information returns by corporations making payments of interest.

Section 6042. Returns regarding corporate dividends, earnings, and profits

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6043. Return regarding corporate dissolution or liquidation

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6044. Returns regarding patronage dividends

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6045. Returns of brokers

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6046. Returns as to formation or reorganization of foreign corporations

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6051. Receipts for employees

This section corresponds to that of the House bill except for a clerical change. The section contains no change from existing law, except that it is made clear in the law that the duplicate copy of Form W-2 must be filed with the Internal Revenue Service when required by regulations.

Section 6061. Signing of returns and other documents

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6062. Signing of corporation returns

This section is identical with that of the House bill.

Present law requires two corporate officers to sign the return. This section permits any one of the officers now named in the law to sign the return, and also permits the corporation to designate any other corporate officer as the one authorized to sign a return. Furthermore, it is provided that the fact that an individual's name is signed on the return shall be prima facie evidence that such individual is authorized to sign the return on behalf of the corporation. It is also specifically required that a receiver or other fiduciary sign any return which he is required to make for a corporation.

Section 6063. Signing of partnership returns

This section, which is identical with that of the House bill, makes no material change from existing law, except that it specifically provides that the signature of one of the partners shall be prima facie evidence that he is authorized by the partnership to sign the return.

Section 6064. Signature presumed authentic

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6065. Verification of returns

This section is identical with that of the House bill.

The present code in numerous places requires returns, etc., to be made under oath, and then in section 3809 permits the Secretary to allow the return, etc., to be made under a declaration under penalties of perjury instead of under oath. Under section 6065, all returns, etc., are to be made under penalties of perjury, except that the Secretary may permit them to be made without such declaration or the Secretary may exercise his authority under subsection (b) to require them to be made under oath. However, as under existing law, the Secretary may not require an oath on individuals' income tax returns and declarations of estimated tax.

Section 6071. Time for filing returns and other documents

This section, which corresponds to that of the House bill except for the addition of a cross reference, contains no material change from existing law.

This section follows the provisions of existing law (see sec. 3310 (f)) in that, with the exceptions stated in succeeding sections, it permits the Secretary to fix by regulations the time for filing returns, notices, and other documents. Under present law returns for occupational taxes are required to be filed on or before the last day of the calendar month in which the special tax liability commences. This provision will permit the Secretary to require returns for certain occupational taxes to be filed prior to the commencement of business if that is deemed desirable.

Furthermore, the authority under existing law to fix special due dates (as distinguished from extensions of time) for the filing of returns in particular cases or classes of cases is continued under section 6071.

Section 6072. Time for filing income tax returns

This section, except for technical and clerical changes, corresponds to that of the House bill.

Subsection (a) of this section extends by an additional month in the case of individuals and partnerships the period allowed for filing income returns. In the case of a calendar year taxpayer, the bill provides that the return is due on or before the 15th day of April instead of the 15th day of March as is required by existing law.

Subsection (d) extends the time for filing returns by exempt cooperatives referred to in section 522 from the 15th day of the third month to the 15th day of the ninth month following the close of the taxable year so as to conform with the period referred to in section 522 (b) (1) (B).

The provisions of section 3805 of existing law relating to the time for filing returns by China Trade Act corporations for taxable years ending before October 1, 1953, are continued in effect in subsection (e), and are extended to the taxable years ending before October 1, 1956.

Specific provision as to the time for filing returns as to the formation, etc., of foreign corporations, as to foreign personal holding companies, and as to returns by corporations contemplating dissolution or liquidation, are not continued in this section. The time for filing such returns will be prescribed by regulations under section 6071.

Section 6073. Time for filing declarations of estimated income tax by individuals

This section is identical with that of the House bill.

In accord with the change made with respect to income tax returns of individuals, the filing date for declarations of estimated tax has been changed from March 15 to April 15 in the case of individuals on the calendar year basis. The other declaration dates of June 15, September 15, and January 15, under existing law are continued without change in this section. Furthermore, section 6073 will treat oyster farming as "farming" for purposes of the estimated tax.

Section 6074. Time for filing declarations of estimated income tax by corporations

This section is identical with that of the House bill.

Under this section a corporation must file its declaration on the 15th day of the 9th month of its taxable year if prior to that month it becomes subject to the requirements of section 6016, and must file the declaration on the 15th day of the 12th month if it becomes subject to those requirements after the 8th month and before the 12th month of the taxable year. A declaration filed in the 9th month may be amended on or before the 15th day of the 12th month.

Section 6075. Time for filing estate and gift tax returns

This section corresponds to that of the House bill except for a substantive change which requires gift tax returns to be filed on or before April 15 instead of March 15.

Under existing law the time for filing estate tax returns is fixed by regulations. This section would fix the time for filing such returns as 15 months after the date of the decedent's death. This conforms to existing law which requires the estate tax to be paid 15 months after the date of the decedent's death.

Section 6081. Extension of time for filing returns

This section, except for a clarifying amendment, corresponds to that of the House bill.

This section extends to all taxes the authority of the Secretary to grant an extension of not more than 6 months for filing returns. Presently this authority is limited to certain taxes, such as the income tax, and in the case of certain other taxes it is limited to 90 days.

The second change from existing law is to grant corporations an automatic 3 months extension for filing income tax returns if a proper form is filed and the tax estimated to be due on the due date for payment of the tax, or the proper installment thereof, is paid on such due date. Under this provision, the Secretary may terminate the automatic extension by giving 10 days' notice.

Section 6091. Place for filing returns or other documents

This section is identical with that of the House bill.

This section permits the Secretary to determine where returns, statements, lists, notices or other documents shall be filed. However, in the case of all tax returns, this section requires such returns to be filed in the internal revenue district determined generally under the same rules as are now prescribed in present section 53 (b) for income-tax returns. As to estate-tax returns, this provision follows present law with respect to estates of decedents domiciled in the United States; for estates of decedents not domiciled in the United States, this provision provides for fixing by regulations the place for filing estate-tax returns, in lieu of the alternative provisions now contained in section 821 (c) of the 1939 Code.

Exceptions to these rules are:

(1) In the case of persons outside of any internal revenue district, the Secretary may choose the place for the filing of the return. Under present law, persons outside the United States are required to file in Baltimore.

(2) The Secretary may permit filing in another district and may require Treasury officers and employees to file in another district.

Section 6101. Period covered by returns or other documents

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6102. Computations on returns or other documents.

This section is identical with that of the House bill.

This section permits the Secretary to allow returns to be filed in whole dollar amounts instead of requiring the showing of cents. The Secretary may require either the elimination of the cents, or rounding to the nearest dollar. However, this section provides that if any taxpayer does not wish to use whole dollar amounts, he may file on the same basis as under present law, that is, by showing exact cents. Furthermore, this provision only applies to the total amount required to be shown on any line on a return, and does not extend to the computation of the various items which are aggregated for the purpose of determining such amount.

This section is not intended to prohibit the use of any penny elimination accounting procedures which are allowable under existing law.

Section 6103. Publicity of returns and lists of taxpayers

This section, which except for a clarifying change corresponds to that of the House bill, contains no material change from existing law.

Section 6104. Publicity of information required from certain exempt organizations and certain trusts

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6105. Compilation of relief from excess profits tax cases

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6106. Publicity of unemployment tax returns

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6107. List of special taxpayers for public inspection

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6108. Publication of statistics of income

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6109. Cross references

This section is identical with that of the House bill.

The cross references contained in this section are to general provisions of law relating to inspection of returns, order forms, etc., of certain supervised industries.

Chapter 62—Time and Place for Paying Tax

Section 6151. Time and place for paying tax shown on returns

This section is identical with that of the House bill.

This section provides a uniform rule that in the case of any tax for which a return is required, the tax shall be paid at the same time and place as that fixed for the filing of the return. This provision accomplishes the same result as existing law with respect to income and gift taxes. In the case of estate taxes existing law provides a 15-month period for paying the tax, but the time for filing the return is left to regulations. Since section 6075 provides that estate-tax returns shall be filed within 15 months after the date of the decedent's death, the uniform rule contained in this provision accomplishes the same result as existing law for the payment of estate tax.

This section states that payment must be made to the principal internal revenue officer for the internal revenue district. This is the officer (formerly known as a collector of internal revenue) who is subject to suit in the district court for refund.

Section 6152. Installment payments

This section is identical with that of the House bill.

This section differs from existing law only to the extent necessary to provide that the amount of corporation tax payable in installments after the close of the taxable year is the unpaid amount, that is, the total amount of the tax reduced by that part of the tax paid currently as estimated tax during the taxable year. For example, if the tax of Corporation A for the calendar year 1955 is $1 million (computed after credits against tax), and if during 1955 it paid a total of $90,000 in 2 installments of estimated tax, the remaining $910,000 would be payable in 2 equal installments of $455,000 each on March 15 and June 15, 1956.

Section 6153. Installment payments of estimated income tax by individuals

This section is identical with that of the House bill.

This section contains no material change from existing law except that the date for filing the declaration and paying the first installment has been changed from the 15th day of the 3d month to the 15th day of the 4th month of the taxable year (April 15 in the case of individuals on the calendar-year basis). This section continues without change the provisions of existing law with reference to the second, third, and fourth installment dates (June 15, September 15, and January 15 in the case of an individual on the calendar-year basis).

Section 6154. Installment payments of estimated income tax by corporations

This section is the same as that of the House bill except for a clerical change. Under the estimated income tax system for corporations, which will become effective with respect to taxable years ending on or after December 31, 1955, the advance payments of tax will be made on the 15th day of the 9th and 12th months of the taxable year. The amount of the tax to be paid on each installment date will increase from 5 percent of the amount due for the entire year in 1955 to 25 percent in 1959 and later years.

Section 6155. Payment on notice and demand

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6156. Payment of taxes under provisions of the Tariff Act

This section, which is identical with that of the House bill, contains references to provisions for collection of certain taxes under the Tariff Act of 1930.

Section 6161. Extension of time for paying tax

This section corresponds to that of the House bill except for technical changes.

This section provides a uniform rule permitting the Secretary to extend the time for payment of any tax or estimated tax shown, or required to be shown, on a return or declaration for a period which may exceed 6 months only in the case of persons abroad. However, the 10-year extension period for estate taxes is retained. Existing law makes no provision for extensions for payment of many taxes, and in the case of a tax imposed by subchapters B, C, or E of chapter 30 of the 1939 code, the extension is limited to 90 days. Section 6161 accomplishes the same result as existing law in the case of income taxes under chapter 1, employment taxes under subchapter C of chapter 9, the estimated tax under chapter 1, and the gift tax under chapter 4, in all of which cases there are specific provisions permitting a 6 months' extension.

Section 6162. Extension of time for payment of tax on gain attributable to liquidation of personal holding companies

This section corresponds to that of the House bill except for conforming changes.

This section which permits a 5-year extension, is, under existing law, applicable only at the request of the taxpayer. In order to permit more latitude in administering the section, this limitation was removed. There is a further change from existing law in that section 6162 is made applicable only to taxable years beginning before January 1, 1956.

Section 6163. Extension of time for payment of estate tax on value of reversionary or remainder interest in property

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6164. Extension of time for payment of taxes by corporations expecting carrybacks

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6165. Bonds where time to pay tax or deficiency has been extended

This section is identical with that of the House bill.

This section applies to all taxes the rule that bond may be required as a condition to an extension of time for payment. This rule is applicable to the income, estate, and gift taxes under existing law.

CHAPTER 63—ASSESSMENT

Section 6201. Assessment authority

This section, which is identical with that of the House bill, makes two material changes from existing law. The first permits the assessment of the amount of any check or money order, given in payment for stamps, which is not duly paid.

There is also a material change from existing law in subsection (a) (3) of this section, relating to erroneous credits for prepayment of income tax (prepayment through credit for tax withheld at source and payments of estimated tax). Under this new paragraph refunds caused by erroneous prepayment credits may be recovered by assessment in the same manner as in the case of a mathematical error on the return. For example, assume a case in which the tax shown on the return is $100, the claimed prepayment credit is $125, and refund of $25 is made, and that it is later determined that the prepayment credits should have been only $70. Under existing law, $30 (the tax of $100 shown on the return less the $70 credit) can be immediately assessed as tax shown on the return which was not paid, but the remaining $25 must be recovered by suit in court. Under the new provision, the entire $55 can be assessed and collected.

Section 6202. Establishment by regulations of mode or time of assessment

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6203. Method of assessment

This section, which is identical with that of the House bill, is a substantial clarification of existing law. It provides that the assessments shall be made by recording the liability of the taxpayer in accordance with rules or regulations of the Secretary. This will permit recording of liability, and hence assessment, through machine operations or through any other modern procedure. The Secretary is directed to furnish to the taxpayer, upon request, a copy of the record of the assessment of that taxpayer's liability.

Section 6204. Supplemental assessments

This section corresponds to that of the House bill except for a clerical change adding a cross reference. It contains no material change from existing law.

Section 6205. Special rules applicable to certain employment taxes

This section, which is identical with that of the House bill, contains no material changes from existing law, except that the adjustment provisions applicable to railroad retirement taxes have been conformed to the adjustment provisions of the other employment taxes.

Section 6206. Cross-references

This section is identical with that of the House bill and contains references to provisions of law relating to assessments.

Section 6211. Definition of a deficiency

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 6212. Notice of deficiency

This section corresponds to that of the House bill except for a clarifying change in subsection (c) (1). It contains no material change from existing law.

Section 6213. Restrictions applicable to deficiencies; petition to Tax Court

This section is identical with that of the House bill. The only material change from existing law is made in subsection (b) (3) of this section, which contains a new provision providing that any amount paid as a tax, or in respect of a tax, may be assessed upon the receipt of such payment notwithstanding the restrictions on assessment contained in subsection (a). It further provides that if such payment is made after the mailing of a notice of deficiency, the assessment shall not deprive the Tax Court of jurisdiction over the deficiency determined without regard to such assessment. If the taxpayer designates the tax in respect of which the payment is made, the assessment under subsection (b) (3) will be made in respect of that tax.

Section 6214. Determinations by Tax Court

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6215. Assessment of deficiency found by Tax Court

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6216. Cross references

This section is identical with that of the House bill.

The cross references contained in this section are to procedures relating to bankruptcy and receivership, jeopardy assessments, and claims against transferees and fiduciaries.

Chapter 64—Collection

Section 6301. Collection authority

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6302. Mode or time of collection

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6303. Notice and demand for tax

This section corresponds to that of the House bill, except for a clarifying change.

This section contains two changes from existing law. The first change is a provision that notice and demand shall be made as soon as practicable, and within 60 days, after the making of an assessment. Existing law requires that notice and demand be made within 10 days after the receipt of the certified list of assessments. The second change is a new provision which states that, except in case of jeopardy, payment shall not be demanded prior to the last date prescribed by law for the payment of the tax. In the case of early returns the tax may be assessed prior to the last date prescribed by law for paying the tax, and this provision is designed to give the taxpayer the benefit of the law which permits him to wait until the last day to pay.

Section 6304. Collection under the Tariff Act

This section, which is identical to that of the House bill, contains references to provisions for collection of certain taxes under the Tariff Act of 1930.

Section 6311. Payment by check or money order

This section is identical with that of the House bill.

Subsection (a) of this section changes existing law so as to permit the Secretary, under regulations, to receive any check or money order in payment for any taxes or stamps. The present law closely limits the type of checks and money orders which may be received in payment for stamps.

Subsection (b) of this section, relating to unpaid checks or money orders, conforms existing law to the change made in subsection (a).

Section 6312. Payment by United States notes and certificates of indebtedness

This section is identical with that of the House bill.

This section changes existing law to permit the same rules to apply with respect to payment for stamps as are now applicable with respect to payment for other taxes. This change conforms to the change with respect to checks and money orders.

Section 6313. Fractional parts of a cent

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6314. Receipt for taxes

This section is identical with that of the House bill.

This section changes existing law to require a receipt to be given only where there is a request for such receipt.

Section 6315. Payments of estimated income tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6316. Payment by foreign currency

This section, for which there is no corresponding provision in the House bill, authorizes the Secretary or his delegate in such cases as he may deem proper, and under such regulations and subject to such conditions as the Secretary or his delegate may prescribe, to accept foreign currency in payment of taxes.

Section 6321. Lien for taxes

This section corresponds to that of the House bill, except that the parenthetical phrase "(including the interest of such person as tenant by the entirety)", which phrase is not included in existing law, has been deleted. It is not clear what change in existing law would be made by the parenthetical phrase. The deletion of the phrase is intended to continue the existing law.

Section 6322. Period of lien

This section is identical with that of the House bill.

This section, which provides that the lien arises at the time the assessment is made, conforms existing law to the change made in section 6203.

Section 6323. Validity against mortgagees, pledgees, purchasers, and judgment creditors

This section corresponds to that of the House bill except for the deletion of subsection (c) of the House bill and conforming changes incident to such deletion.

Subsection (c) of the House bill provided certain rules with respect to the validity of the tax lien, without the filing of notice thereof, as against mortgagees, pledgees, purchasers, or judgment creditors. The applicable rules have been developed under existing law by judicial construction, and your committee deems it advisable to continue to rely upon judicial interpretation of existing law instead of attempting to prescribe specific statutory rules. The deletion of subsection (c) will continue in effect the existing law.

This section corresponds to section 3672 of the 1939 Code. As under existing law, a person who is in fact a mortgagee, pledgee, purchase, or judgment creditor will be entitled as such to the protection of this section irrespective of the designation applied to such person under State law, for example, in a State which has adopted the Uniform Commercial Code and which uses other terms to describe such persons.

Subsection (b) of this section makes it clear that the notice of lien shall be valid, notwithstanding any law of the State or Territory regarding the form or content of a notice of lien, if the notice is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a) (2) of this section. The Treasury Department has consistently taken the position that section 3672 of the 1939 Code and the corresponding provisions of prior law authorize the State or Territory only to designate the local office for the filing of the notice of the lien. Subsection (b) is designed to eliminate any question as to the validity of the lien as against mortgagees, pledgees, purchasers, and judgment creditors, where notice thereof is filed in the office designated by the law of the appropriate State or Territory, even though the notice does not comply with other requirements of the law of the State or Territory as to the form or content of the notice. For example, the omission from the notice of lien of a description of the property subject to the lien would not affect the validity thereof, even though the law of the State or Territory requires that the notice of lien contain a description of the property subject to the lien. Subsection (b) of this section is declaratory of the existing procedure and in accordance with the long-continued practice of the Treasury Department.

Subsection (c) of this section as redesignated by your committee is in all material respects the same as existing law.

Subsection (d) of this section as redesignated by your committee makes it clear that the Secretary may, after a notice of lien has been filed (and such notice discloses the amount of the outstanding liability as of the time of filing), disclose the extent to which the original obligation has been reduced by subsequent payments. This is necessary for the protection of persons dealing with property subject to the lien who have a legitimate interest in determining the amount of the outstanding obligation, as well as to aid reestablishment of the taxpayer's credit.

Section 6324. Special liens for estate and gift taxes

This section corresponds to that of the House bill except for a conforming change.

With certain exceptions this section continues in effect the provisions of existing law with respect to personal liability and the liens for estate and gift taxes. Provisions of present law imposing personal liability for the taxes have been continued, except that a trustee of an employee's trust which meets the requirements of section 401 (a) is relieved of personal liability for the estate tax. Present law regarding the divestment of the estate and gift tax liens has been broadened to include transfers of property to a bona fide mortgagee or pledgee for adequate and full consideration, including transfers by transferees of a transferee. In addition, existing law has been modified to provide that the estate or gift tax lien shall not be valid as against a purchaser, mortgagee, or pledgee of a security (as defined in section 6323 (c) (2)) for full and adequate consideration and without notice or knowledge of the existence of such lien.

Section 6325. Release of lien or partial discharge of property

This section corresponds to that of the House bill except for a technical change. The section in the House bill contained no material change from existing law. Your committee revised subsection (b) (2) of the House bill to include an express provision that if the Secretary determines that the interest of the United States in a particular piece of property subject to lien is valueless, he may issue a certificate discharging such property from the lien.

Section 6326. Cross references

This section, which is identical with that of the House bill, contains references to general provisions of law relating to liens and bankruptcy proceedings.

Section 6331. Levy and distraint

This section corresponds to that of the House bill except for the revision noted below and a clerical change. The section continues in effect the provisions of existing law relating to distraint and levy (see secs. 3690 and 3692 of the present Internal Revenue Code).

Your committee has clarified the provisions of the House bill by expressly providing that accrued salary or wages of any officer, employee, or elected official of the United States or the District of Columbia, or of any agency or instrumentality thereof, may be levied upon by serving a notice of levy on the employer (as defined in sec. 3401 (d)) of such officer, employee, or elected official. The change in this section makes unnecessary the change from existing law in the definition of "person" in section 6332 (c) of the House bill, and accordingly that section has been amended to restore the definition of "person" contained in section 3710 (c) of the 1939 code. The provisions as to levy on salaries of Government employees are the same as those applicable to any other delinquent taxpayer.

The section retains the rule of present law which permits seizure immediately after notice and demand in the case of jeopardy, and in cases not involving jeopardy permits seizure only after the expiration of the 10-day period following the issuance of notice and demand. However, existing law provides for immediate seizure only with respect to taxes other than income, estate, and gift taxes. The section changes present law with respect to jeopardy cases by permitting seizure immediately after notice and demand in the case of all taxes, including income, estate, and gift taxes.

Existing law requires that levy proceedings must be carried on against personal property and then used against real property. Under this section real property may be levied upon without first proceeding against personal property.

Section 6332. Surrender of property subject to levy

This section corresponds to that of the House bill except for a conforming change required by the amendment to section 6331.

Section 6333. Production of books

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6334. Property exempt from levy

This section corresponds to that of the House bill except that arms for personal use, livestock, and poultry are enumerated in the second exemption from levy among the items applicable to the head of the household.

This section is a modernization of existing law with respect to property exempt from levy. The first exemption covers wearing apparel and schoolbooks necessary for the taxpayer or for members of his household. No specific value limitation is imposed with respect to this item since the intent is to prevent seizing the ordinary clothing of the taxpayer or members of his household. The section is not intended to exempt from seizure expensive furs and similar items which are luxuries and not necessities. The second exemption from levy is applicable only in the case of the head of a household, and applies to only so much of the fuel, provisions, furniture, arms for personal use, livestock, poultry, and personal effects, used by the household, as does not exceed $500 in value. The third item in the enumeration is for so many of the books and tools necessary for the trade, business, or profession of the taxpayer as does not exceed in the aggregate $250 in value.

This section provides that the officer making the seizure shall appraise and set aside to the owner the property declared exempt, and, if the taxpayer objects to such valuation at the time of the seizure, the officer making the levy shall summon three disinterested individuals to make the valuation.

Subsection (c) of this section states that no property or rights to property, other than the properties specifically made exempt in this section, shall be exempt from levy by reason of any other law of the United States. Provisions of State law cannot grant an exemption from levy, and this subsection makes it clear that no other provision of Federal law shall exempt property from levy. This section is not intended to make any change with respect to the status of life insurance policies insofar as levy thereon is concerned.

Section 6335. Sale of seized property

This section corresponds to that of the House bill except for a substantive change in subsection (b) as noted below.

This section differs from existing law in that it treats real and personal property together and generally mak~~es no~~ distinction between the two.

The time of sale has been fixed at not less than 10 days nor more than 40 days from the time of giving public notice of sale. Under existing law the rule is from 10 to 20 days after notice to the owner in the case of personal property, and 20 to 40 days in the case of real property. This section merges the two periods and makes the period run from the date of public notice rather than from the date of notice to the owner.

Subsection (a) of this section continues the provision of existing law for the giving of notice of seizure to a person whose property is seized. A new provision added in this subsection permits the Secretary to mail a notice to the last known address of the delinquent person whenever he cannot be readily located or has no dwelling or place of business within the internal revenue district.

Section (b) of this section provides for the giving of notice of sale to the owner. Under existing law, this notice of sale is incorporated with the notice of seizure. Under this provision, notice of seizure and sale may be given simultaneously but the provision also permits the notice of sale to be given at a later time. This change is intended to permit a person to get notice of seizure more promptly than would be possible if the Secretary had to wait until he determined the exact date, place and conditions of sale.

In the case of the notice of sale, the section further changes existing law (which requires notice only of the time and place of sale) to further provide that the notice must state the manner and condition of the sale.

Existing law requires that the place of sale must be not more than 5 miles distant from the place of making the distraint, or from the seized property in the case of real estate. In the case of real estate, however, the 5-mile rule may be ignored by special order of the Commissioner. This section changes existing law by providing that the sale must take place within the county in which the property was seized, except by special order of the Secretary.

Your committee has made a change in subsection (b) with respect to cases where the tax is in jeopardy and levy is made without regard to the 10-day period after notice and demand provided in section 6331 (a). In the case of such levy, public notice of sale shall not be made within such 10-day period unless the property is of the type described in section 6336.

A further change from existing law is contained in subsection (c), relating to the manner and conditions of the sale. In this subsection will be found provisions relating to the minimum price at which the sale shall be made, which provisions correspond to those of existing law. The first change in existing law is a provision that the Secretary or his delegate shall by regulations prescribe the manner and other conditions of the sale of properties. This provision is designed to give the Internal Revenue Service latitude to provide modern rules for selling property in the best manner possible. The subsection states that the regulations shall provide that the sale shall not be conducted in any manner other than by public auction or by public sale under sealed bids. Existing law requires all such sales to be conducted by public auction. The subsection also permits the regulations to provide for selling the property item by item, in groups, in the aggregate, or by both separate sale and aggregate sale, with whichever sale produces the higher amount being the final one.

The second change in existing law made by subsection (c) is the provision which permits the regulations to provide that the announcement of the minimum price may be deferred until the receipt of the highest bid. The intent of such a provision is to prevent announcement of the minimum price from depressing the amount of the bid. The subsection also specifically refers to authority by regulations to use other methods for advertising the sale in addition to those required in the giving of public notice (for example, in trade journals in the case of special machinery).

Subsection (c) of this section makes a further change in existing law by providing that the sale may be made for a partial down payment and a subsequent payment of the balance of the amount bid. Under existing law the entire amount of the highest bid must be paid at the time of sale. Since a higher bid might be obtained if the purchaser were permitted a reasonable time to raise the balance of the bid (in cases where he makes a reasonable down payment), the section gives the Secretary authority to provide for such cases by regulations. Under this provision payment of the balance may be deferred for a period not to exceed 1 month. Furthermore, if the balance of the amount bid is not paid within the period allowed, the Secretary may either proceed to sell the property again (and in such case the part payment shall be forfeited and the second purchaser shall take free and clear of all claim of the defaulting purchaser), or the Secretary may at his election bring suit against the purchaser for the unpaid balance with interest at 6 percent.

For restrictions on sale of seized property pending Tax Court decision after a jeopardy assessment, see the explanation under section 6863 (b) (3).

Section 6336. Sale of perishable goods

This section is identical with that of the House bill.

Existing law contains provisions to cover the sale of forfeited perishable property but not of such property levied upon. The principles of the provisions relating to forfeited property have been adopted in this section for the sale of perishable goods seized by levy. In addition to perishable goods, the section also covers property which cannot be kept without great expense. This section provides that the taxpayer shall be given an immediate opportunity to pay the appraised value of the property or give satisfactory bond for such payment, and in such case the property will be returned to him. If he fails to pay such amount or give bond, the Secretary may as soon as practicable make public sale of the property in accordance with regulations. In case a bond is given, the section specifically permits payments secured by the bond to be made at such time as the Secretary determines to be appropriate under the circumstances. This provision will permit the collection officials to take into account normal commercial practices for the disposal of such property.

Section 6337. Redemption of property

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6338. Certificate of sale; deed of real property

This section is identical with that of the House bill.

Existing law requires that a certificate of sale be given to the United States in cases in which the property is purchased at a minimum price for the account of the United States. This section eliminates this provision as being obsolete under modern practice. However, the provision for giving deed for real property purchased at the minimum price by the United States is retained, since the recording of such deed in the local registry is necessary to keep local property titles in order.

Section 6339. Legal effect of certificate of sale of personal property and deed of real property

This section corresponds to that of the House bill, except for a clerical change.

This section changes existing law by the addition of a new provision with respect to the recording of the transfer of title of motor vehicles sold after seizure for taxes. These provisions correspond to those now in the law authorizing the transfer of corporate stocks. The new provision states that any public official charged with registration of title to motor vehicles shall make the transfer in his records upon receiving notice of the certificate of sale in the same manner as if the certificate of title to the motor vehicle were transferred or assigned by the party holding it. This new provision will keep the public records of title to motor vehicles in proper order.

Section 6340. Records of sale

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6341. Expense of levy and sale

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 6342. Application of proceeds of levy

This section is identical with that of the House bill.

This section continues in effect the existing law which requires the proceeds of the sale to be applied against the expenses of the levy and sale, against any specific Federal tax liability on the seized property, and against the liability of the delinquent taxpayer, and for any surplus proceeds to be paid over to the person or persons entitled thereto.

Section 6343. Authority to release levy

This section is identical with that of the House bill.

This section permits a levy to be lifted, or seized property to be returned, if the Secretary determines that such action will facilitate the collection of the tax liability; for example, where the taxpayer makes a proper agreement with the collecting authorities whereby he undertakes to pay the liability in installments.

Section 6344. Cross references

This section, which except for a clerical change corresponds to that of the House bill, contains references to levy provisions.

Chapter 65—Abatements, Credits, and Refunds

Section 6401. Amounts treated as overpayments

This section, which is identical with that of the House bill, makes no material change from existing law.

Section 6402. Authority to make credits or refunds

This section, which is identical with that of the House bill, changes existing law so as to permit expressly the crediting of interest on an overpayment against any outstanding liability for any tax.

Section 6403. Overpayment of installment

This section, which is identical with that of the House bill, extends to any tax payable in installments the provisions of existing law applicable to the income tax.

Section 6404. Abatements

This section is identical with that of the House bill. A change from existing law is contained in subsection (c) of this section. It provides that the Secretary may (but is not required to) abate the unpaid portion of the assessment of any tax or any liability in respect thereof, if it is determined that the administration and collection cost involved would not warrant collection of the amount due. This section recognizes the practice of a number of years adopted under the general administrative authority of the Department.

Section 6405. Reports of refunds and credits

This section, which is identical with that of the House bill, makes no material change from existing law, except that the section will apply to refunds and credits in excess of $100,000. Under existing law it is applicable only to refunds and credits in excess of $200,000. Under an amendment made by your committee to section 7851, this change will be applicable to refunds and credits allowed (as determined under sec. 6407) after the date of enactment of this title.

Section 6406. Prohibition of administrative review of decisions

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6407. Date of allowance of refund or credit

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6411. Tentative carryback adjustments

This section, which is identical with that of the House bill, contains no material change from existing law, except that the decrease in tax may under this section be applied against any tax due from the taxpayer. Existing law permits the application only against income taxes.

Section 6412. Floor stocks refunds

This section in the House bill made no change from the then existing law. Thereafter, the Excise Tax Reduction Act of 1954 was enacted. Your committee has changed the section to conform to that Act.

Subsection (a) of the House bill incorporated the provisions of the 1939 Code relating to floor stocks refunds on electric light bulbs. These provisions of the 1939 Code have already become effective as a result of the Excise Tax Reduction Act of 1954, and have therefore been deleted from this section which will become effective after those provisions have served their purpose. The Excise Tax Reduction Act of 1954 added to the 1939 Code new provisions for floor stocks refunds of the tax on motor vehicles, and these provisions have been added by your committee to this section as subsection (a) thereof.

The effective date of the floor stocks refund on gasoline, provided for in subsection (b) of the House bill, is changed in the reported bill to April 1, 1955, to conform to the Excise Tax Reduction Act of 1954.

Subsections (c) and (d) of the House bill have been redesignated as subsections (d) and (e), and a new subsection (c), relating to the applicability of the general administrative provisions to the floor stocks refunds of the taxes on motor vehicles and gasoline, has been inserted by your committee for the purposes of clarity.

Section 6413. Special rules applicable to certain employment taxes

This section, which is identical with that of the House bill, makes two changes from existing law. The first change conforms the provisions relating to the adjustment of railroad retirement taxes to the adjustment provisions of the Federal Insurance Contributions Act. The second change will treat special refunds of employee tax under the Federal Insurance Contributions Act in the same manner as an overpayment of tax.

Section 6414. Income tax withheld

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6415. Credits or refunds to persons who collected certain taxes

This section corresponds to that of the House bill except for a clerical change to conform to the Excise Tax Reduction Act of 1954.

Existing law expressly provides in the case of taxes on transportation and safe-deposit boxes that credit or refund is made only upon a showing that the taxpayer has not passed on the tax. This section makes it clear that this rule applies to taxes on admissions and club dues.

Section 6416. Certain taxes on sales and services

This section corresponds to that of the House bill except for clerical changes, changes to conform to the Excise Tax Reduction Act of 1954, and a revision of the provision in the House bill relating to the requirement that credit or refund will be made only if there is a showing that the tax has not been passed on. Under the House bill this requirement was applicable in the case of overpayments determined under paragraph (1) (relating to price readjustments) and paragraph (3) (relating to tax-paid articles used for further manufacture) of subsection (b). Under your committee's amendment, this requirement will not be applicable to overpayments determined under such paragraphs.

Subsection (a) of this section extends to the cabaret tax the rule that credit or refund will be made only if there is a showing that the tax has not been passed on.

Subsection (b) of this section makes several changes in existing law. First, the provisions of existing law, treating certain cases in which payments are considered overpayments by reason of a price adjustment between the seller and the purchaser, have been extended to the tax on diesel fuel and the tax on pistols and revolvers. However, under this section credit or refund shall be made without interest in any case where the overpayment is caused by price readjustment. This is the rule of existing law with respect to manufacturers' excise taxes. Existing law contains a similar provision prohibiting interest in respect of manufacturers' excise taxes and the tax on diesel fuel where the article is sold for certain specified uses or resale. This section extends this provision to retailers' excise taxes.

Section 6417. Coconut and palm oil

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6418. Sugar

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6419. Excise tax on wagering

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6420. Cross references

This section is identical with that of the House bill.

This section contains references to general provisions of law relating to credits, refunds, overpayments, and abatements.

Chapter 66—Limitations

Section 6501. Limitations on assessment and collection

This section corresponds to that of the House bill, which made several changes in existing law to achieve as much uniformity as possible with respect to all taxes, except for clarifying and substantive changes as hereinafter noted.

Subsection (a) provides a 3-year rule for the assessment of taxes, commencing with the date the return was filed or, in the case of stamp taxes, with the date the taxes become due. The period for proceeding in court without assessment is the same period. This rule is existing law only with respect to income, estate, gift, social-security taxes, and income tax withholding on wages.

Subsection (b) of this section extends the existing income-tax rule that an early return shall be deemed filed on the due date for statute of limitations purposes. The provisions of this subsection extend this rule to all taxes for which returns are required. This subsection also changes existing law in that the execution of a return by the Internal Revenue Service will not constitute the making of a return for the purpose of starting the running of the statute of limitations on assessment.

Paragraph (2) of subsection (c) which provides that there shall be no limitation on assessment or proceeding in court in the case of a willful attempt in any manner to defeat or evade tax and which is existing law as to all taxes other than income, estate, and gift taxes was extended to the latter taxes by the House bill but your committee has restored existing law.

Paragraph (4) of subsection (c) contains the existing provision of the income-tax law permitting an extension of time for assessment by written agreement between the taxpayer and the Internal Revenue Service, and extends this rule to all taxes except the estate tax imposed by chapter 11.

Subsection (d) of this section provides an 18-month period of limitation where there is a request for prompt assessment by an executor or other fiduciary representing the estate of a decedent or a corporation in liquidation. Under existing law this rule is applicable only to the income taxes of the decedent, the estate, or the corporation. This subsection extends the rule to all taxes payable by return other than the estate tax. The subsection includes a new provision which requires the written request for prompt assessment to be filed in such manner and such form as may be prescribed by regulations.

Several changes from existing law have been made in subsection (e) of this section. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term "gross income" as used in this paragraph has been redefined to mean the total of the amounts received or accrued from the sale of goods or services prior to diminution by the cost of such sales or services. A further change from existing law is the provision which states that any amount as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent.

Paragraph (2) of subsection (e) applies to estate and gift taxes a rule, corresponding to the income-tax rule, for an extended period of limitation where, in the return, there is a 25-percent omission from the amount of the gross estate or from the amount of the taxable gifts made during the year. This paragraph also includes provisions to the effect that any item as to which adequate information is given on the return shall not be taken into account in determining the 25 percent omission. This paragraph is the same as that of the House bill except for a clarifying change made by your committee to make certain that an increase in the valuation of an item shown on the return will not bring into operation the 25-percent omission rule.

The provision in existing law for a 7-year period of limitation where a taxpayer fails to include in gross income his distributive share of the income of a foreign personal holding company has been changed to 6 years.

Subsection (f) of this section provides that the personal holding company tax may be assessed or a proceeding in court for the collection of such tax may be begun without assessment at any time within 6 years after the return was filed, in cases where a personal holding company fails to file with its income tax return for such year a schedule setting forth certain information as to items of gross income received or the names and addresses of individuals who own more than 50 percent in value of the outstanding capital stock of the corporation.

Subsection (g) corresponds to the same subsection of the House bill except that your committee has added a new paragraph thereto. Paragraph (1) of subsection (g), which is identical to subsection (g) of the House bill, represents a change designed to achieve in a better fashion the purpose of section 275 (g) of existing law. That section provides a 4-year period of limitations where taxable corporations make no return, but the shareholders include in their income their distributive share of the net income of the corporation. Paragraph (1) of subsection (g) provides that if a trust or partnership return is filed in good faith by an association taxable as a corporation, such return shall be deemed the return of the corporation for purposes of measuring the running of the period of limitation.

Paragraph (2) of subsection (g), which had no counterpart in the House bill, provides that if a taxpayer determines in good faith that it is an exempt organization for a taxable year and files a return under section 6033, such return shall be deemed the return of the corporation for purposes of the running of the period of limitation on its income tax liability for the taxable year.

Section 6502. Collection after assessment

This section, which is identical with that of the House bill, makes one material change from existing law by providing that an agreement extending the period for collection may be made after the 6-year period has expired if there is a release of levy under section 6343 and if made before such release. See the discussion of section 6343.

Section 6503. Suspension of running of period of limitation

This section corresponds to that of the House bill except for a substantive change in subsection (b).

Two changes from existing law are made in subsections (b) and (c) of this section. Subsection (b) of the House bill provides that the period of limitation on collection after assessment shall be suspended for the period that the assets of the taxpayer are in the control or custody of a court, and for 6 months thereafter. Existing income-tax law provides that in the case of bankruptcy or receivership, any portion of the claim allowed may be collected within 6 years after the termination of the proceedings; this subsection provides a uniform rule applicable to all taxes. Your committee has changed the House bill to provide that this provision will not apply to probate or guardianship cases, that is, where the assets of a decedent or of an incompetent are in the control or custody of the court.

Subsection (c) of this section is a new provision which states that the period of limitations on collection after assessment shall be suspended for the period collection is hindered or delayed because property of the taxpayer is situated or held outside of the United States, or is removed from the United States. The total suspension of time under this provision shall not in the aggregate exceed 6 years.

Section 6504. Cross references

This section corresponds to that of the House bill except for a conforming change.

This section contains appropriate references to provisions relating to limitations on assessments and collection.

Section 6511. Limitations on credit or refund

This section corresponds to that of the House bill except that your committee has provided that the 3-year period (as distinguished from the 2-year period after payment) for filing claims for credit or refund shall run from the due date of the return (determined without regard to any extension of time for filing) instead of from the date the return was filed.

Subsection (a) of this section provides, for all taxes in respect of which a taxpayer is required to file a return, that the period of limitations for credit or refund shall be 3 years from the time the return is due (determined without regard to any extension of time for filing), or 2 years from the time the tax is paid, whichever of such periods expires the later, and in cases in which no return is filed the period is 2 years. In the case of stamp taxes, subsection (a) provides a period of 3 years from the time the tax was paid. These provisions are consistent with the new u iform rule in section 6501, relating to the period of limitation on assessments. Existing law, except in the case of income, estate; gift, and certain employment taxes, provides a 4-year period.

Subsection (c) of this section extends to all taxes, except the estate tax imposed by chapter 11, the rule, now applicable to the income tax, that the period of limitation for credit or refund shall not expire prior to the end of 6 months after any extension of the period for assessment agreed upon between the taxpayer and the Internal Revenue Service. The provision authorizing such extensions of the period for assessment, which under existing law applies only to the income tax, has been made applicable to all taxes except the estate tax imposed by chapter 11, and this subsection extends the corresponding rule on refunds to the same taxes.

Paragraph (3) of subsection (d) provides a special 10-year period of limitation with respect to refunds resulting from foreign taxes paid or accrued, which may be claimed as a credit against the tax imposed by chapter 1 in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party.

Subsection (e) corresponds to existing law except for the 2-year period in paragraph (1), which period is 1 year under existing law.

Section 6512. Limitations in case of petition to Tax Court

This section of the House bill, which contains no material change from existing law, was adopted by your committee with two clarifying changes.

Section 6513. Time return deemed filed and tax considered paid

This section corresponds to that of the House bill except for a clerical and a conforming change in subsection (b).

Subsection (a) of this section extends to all other taxes, in respect of which the taxpayer is required to file a return, the existing income-tax rule as to early returns and advance payment. Under this rule an early tax return or an advance payment of tax is deemed made, for the purpose of starting the period of limitation for credit or refund, on the due date of the return or the payment.

Subsection (b), relating to the credits for withheld income tax on wages and payments of estimated tax, corresponds to existing law in that the presumptive date of payment is the due date of the corporation or individual income tax return, as the case may be, determined without regard to any extension of time for filing such return.

Subsection (c), relating to presumptive dates in the case of returns and payments of social-security taxes and income-tax withholding, contains a similar change to conform to the new filing date.

Subsection (d) of this section clarifies the rule applicable in a case in which an overpayment of income tax is claimed on the return as a credit against estimated tax for the next year. In many cases the taxpayer fails to reflect on the estimated tax return the amount so claimed. This subsection provides that, in such a case, the amount of the overpayment for the first year shall be treated as a payment for the second year, that is, the year for which the estimated tax is paid, and the applicable period of limitations shall be determined with respect to the second year.

Section 6514. Credits or refunds after period of limitation

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 6515. Cross references

This section corresponds to that of the House bill except for a conforming change.

This section contains appropriate references to provisions relating to limitations on credit or refund.

Section 6521. Mitigation of effect of limitation in case of related taxes under different chapters

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 6531. Periods of limitation on criminal prosecutions

This section corresponds to that of the House bill except for the changes described below.

The House bill changed existing law by providing that the 6-year period of limitations shall apply to (1) the offense of willfully failing to pay the tax or make any tax return at the time or times required by law or regulations; (2) the offenses described in sections 7206 (1) and 7207, relating to false statements and fraudulent documents; (3) the offense described in section 7212 (a), relating to intimidation of officers and employees of the United States; and (4) the offenses described in section 7214 (a) committed by officers and employees of the United States. Your committee has restored the existing law with respect to the period of limitations applicable to each of these offenses.

The House bill also changed existing law by providing that the period of limitations shall be suspended during the period the taxpayer is outside the territorial limits of the United States, and by expressly referring to the suspension of the period of limitations while the taxpayer is a fugitive from justice. Under existing law the period of limitations is suspended during the period the taxpayer is outside of the judicial district in which the offense was committed. Your committee has provided that, in any case under the 1939 Code where the period of limitations would expire more than 3 years after the date of enactment of this title, this change in existing law shall be applicable in lieu of the sentence in section 3748 (a) of the 1939 Code which relates to the time during which a person committing an offense is absent from the district wherein the same is committed, except that in any such case in which this provision is applied the period of limitations shall not expire prior to 3 years after the date of enactment of this title.

This section also provides that for purposes of the period of limitations on criminal prosecutions the rules of section 6513 shall be applicable.

This section and that of the House bill further provide that if a complaint is instituted before a commissioner of the United States, within the prescribed period of limitations, the period of limitations shall not expire prior to the date which is 9 months after the date of the making of the complaint. Under existing law, the extension of time is until the discharge of the grand jury at its next session within the district.

Section 6532. Periods of limitation on suits

This section corresponds to that of the House bill except for a substantive change in subsection (b).

Subsection (a) of this section makes two changes from existing law. Paragraph (2) of subsection (a) provides that the 2-year period of limitation for filing suit may be extended in any case for such period as may be agreed upon in writing between the taxpayer and the Secretary. Existing law permits the period to be extended only to the date of final decision in one or more named cases then pending before the Tax Court or the courts.

Paragraph (3) of subsection (a) contains a new provision which states that if the taxpayer files a written waiver of the requirement that he be sent a notice of disallowance of his claim for refund, then the 2-year period for filing suit for such refund begins to run on the date such waiver is filed.

In subsection (b) of this section your committee has restored existing law by changing from 6 years to 5 years the period in which the United States may bring suit to recover an erroneous refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

Section 6533. Cross references

This section, which is identical with that of the House bill, contains references to general provisions of law relating to the running of the statute of limitations.

Chapter 67—Interest

Section 6601. Interest on underpayment, nonpayment, or extensions of time for payment, of tax

This section corresponds to that in the House bill except for a conforming change and for a change to provide that if notice and demand is made for payment of tax, and if the amount demanded is paid within 10 days after such notice and demand, interest will not be imposed upon such amount for the period subsequent to the date of the notice and demand.

Subsection (a) of this section provides a general rule that interest at the rate of 6 percent shall run from the due date to the date paid in the case of any amount of tax which is not paid on the due date. The only exception to this general rule is contained in subsection (b), which subsection retains the provisions of existing law with respect to the 4-percent rate charged in the case of the estate tax where an extension is granted because payment would result in undue hardship or where postponement of payment is permitted in the case of the tax attributable to the value of reversionary or remainder interests in property.

Under this section, the due date is determined without regard to any extension of time, and interest will be collected during the period of the extension, and for any further period during which the tax remains unpaid. This is true under existing law, except that on the date the extension ends the interest charged for the period of the extension begins to bear interest. Under the provisions of this section, there is no interest on interest. Under existing law, in the case of deficiencies in income, estate or gift taxes, interest runs from the date prescribed for payment of the tax to the date of assessment of the deficiency and then interest on the amount assessed runs from the date of assessment.

In the case of stamp taxes which are not paid, there is no interest under existing law until the tax is assessed. Under the provisions of this section, interest will run from the date the liability for the tax arises.

This section also provides several rules for determining the last date prescribed for payment in addition to the rules noted above. One rule is that in the case of installment payments, interest on any portion of the tax not shown on the return will run from the due date of the first installment. In the case of any unpaid installment of tax shown on the return, interest shall run from the installment date. If notice and demand for subsequent installments is issued under section 6152 (d), interest on such subsequent installment runs from the date of notice and demand. Another rule is designed to cover those cases where, by reason of jeopardy, payment is demanded before the due date otherwise prescribed. In such cases, interest will not begin to run prior to the due date otherwise prescribed, since the jeopardy procedure is merely designed to obtain advance payment of the tax.

One exception to these general rules is a continuation (with a minor variation) of the provision of existing law that, where a waiver of the restrictions on assessment (Form 870) is filed, interest is not imposed on income, estate, and gift tax deficiencies during the period beginning 30 days after filing of the waiver and ending with the date of notice and demand (instead of the date of assessment as under existing law).

Another exception to the general rule makes a minor modification of the effect of the Seeley Tube & Box Co. decision (338 U. S. 561). Under this section, interest on a deficiency which is eliminated by a carryback will run from the original due date of the tax to which the deficiency relates to the end of the taxable year in which the net operating loss arises. (A corresponding change has been made in the provisions for interest on refunds caused by carrybacks.) The 6 percent interest provisions of this section supersede the provision in section 3779 of existing law for 3 percent interest in the case of extensions of time to certain corporations expecting carrybacks.

Section 6602. Interest on erroneous refund recoverable by suit

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6611. Interest on overpayments

This section corresponds to that of the House bill except for a clerical amendment. The section provides that in determining the date of the overpayment in order to compute interest on the overpayment, the same rules as to presumptive dates of payment shall be applied as are applied for the purpose of measuring the period of limitations on refund or credit. Subsection (e) of this section provides that if any overpayment of tax imposed by subtitle A (income taxes) is refunded within 45 days after the last date prescribed for filing the return of such tax (determined without regard to any extension of time for filing the return), no interest shall be allowed on such overpayment.

Existing law denies interest on an overpayment caused by a carryback for any period prior to the filing of a claim for credit or refund of such amount (or filing a petition with the Tax Court with respect to such amount). Under this section, interest is denied only for the period prior to the close of the taxable year in which the net operating loss arises. This is consistent with the rule for interest on underpayments (see the discussion of sec. 6601).

Your committee has deleted those provisions in subsection (g) of this section of the House bill which duplicate those of section 6406, relating to prohibition of administrative review, and has substituted a cross reference to section 6406.

Section 6612. Cross references

This section, which is identical with that of the House bill, contains references to general provisions of law relating to interest on judgments for overpayments and to restrictions on interest.

Chapter 68—Additions to the Tax, Additional Amounts, and Assessable Penalties

Section 6651. Failure to file tax return

This section corresponds to that of the House bill except for a conforming change and a technical change. The technical amendment includes in subsection (a) of this section a reference to subchapter A of chapter 53 (relating to machine guns and certain other firearms).

Subsection (a) of this section provides a uniform general rule as to the additions to tax for failure to file a tax return. This rule, which corresponds to the present rule for income taxes, is applicable to all taxes in respect of which a taxpayer is required to file a return. Under this rule, a taxpayer may avoid the addition to the tax for delinquent filing by showing that the delinquency was due to reasonable cause regardless of whether a return is ever filed by him. This is existing law with respect to income taxes. However, with respect to many other taxes imposed by the present code, existing law requires that a return be filed by the taxpayer before consideration is given as to whether or not there was reasonable cause for his failure to file.

Subsection (b) of this section provides that the addition to the tax will be computed on the net amount due on the return rather than on the gross amount of tax required to be shown on the return. This provision is important in the case of the income tax where a large part of the amount of the tax shown on the return may have been prepaid through declaration of estimated tax or through income tax withholding on wages.

Section 6652. Failure to file certain information returns

This section corresponds to that of the House bill except for a clerical change.

This section provides that there shall be paid $1 for each required statement of information (such as each Form 1099 required to be filed, or each copy of Form W-2 required to be attached to Form 941 for the last quarter of the year) which is not filed, but the total amount to be paid for any one calendar year in the case of any one person shall not exceed $1,000.

A clerical change has been made by your committee to conform the reference to section 6041 in this section to the revised heading of section 6041.

Section 6653. Failure to pay tax

This section corresponds to that of the House bill except for one substantive change. Your committee has amended subsection (a) to provide that the addition to the tax of 5 percent of the underpayment in income and gift tax cases shall not be made where a taxpayer in good faith intentionally disregards rules and regulations because he reasonably believes the rules or regulations are invalid and attaches to his return an adequate statement which sets forth the rules or regulations disregarded and the grounds for believing them invalid.

Subsection (a) prescribes an addition to the tax of 5 percent of the underpayment in income tax and gift tax return cases for underpayments of tax resulting from negligence or intentional disregard of rules and regulations, subject to the above indicated change made by your committee.

For all taxes for which returns are required, this section prescribes additions to the tax, corresponding to those of existing law relating to the income tax, for underpayments of tax resulting from fraud (50 percent of the underpayment). Existing law imposes a 50 percent addition in the case of fraud applicable to all taxes, but, in the case of taxes other than income, estate, and gift, that addition is based on the total amount of tax imposed. This section further provides that if the 50 percent penalty resulting from fraud is assessed, the addition to tax under section 6651 for failure to file a return will not be assessed with respect to the same underpayment. Another change provided in this section is the substitution, for the penalty provided in existing law of an amount equal to the amount of any stamp tax evaded or not paid, of an addition to the tax of 50 percent of the total amount of the underpayment of such tax.

Section 6654. Failure by individuals to pay estimated income tax

This section corresponds to that of the House bill, except for a substantive change in subsection (d), the redesignation of subsection (e) as subsection (f) with a technical change therein, and the addition of new subsections (e) and (g).

This section is a new provision which supersedes the penalties provided by section 294 (d) of existing law.

Subsections (a), (b), and (c) substitute, for the charges under existing law for failure to comply with the provisions relating to the estimated tax, a single charge of 6 percent per annum, computed for each installment date on the difference between the amount paid and 70 percent (66⅔ percent in the case of farmers) of the amount which should have been paid. The charge would run until the amount is paid or until the filing date for the tax return, whichever is earlier. For example, a taxpayer (other than a farmer) showing a tax liability of $40,000 on his final return has paid a total of $20,000 in equal installments of $5,000 during the year through withholding and declarations. Since the amount of prepaid tax in each quarter is less than one-quarter of 70 percent of the final tax liability, the charge is applicable for each quarter and would be computed as follows:

(1)	Tax liability	$40, 000
(2)	70 percent of tax liability	28, 000
(3)	¼ of 70 percent	7, 000
(4)	Deduct quarterly prepayment	5, 000
(5)	Basis for computation of charge (line 3 minus line 4)	2, 000
(6)	Additional charge:	
	(*a*) 1st quarter—6 percent of $2,000 for 365 days	120. 00
	(*b*) 2d quarter—6 percent of $2,000 for 304 days	99. 95
	(*c*) 3d quarter—6 percent of $2,000 for 212 days	69. 70
	(*d*) 4th quarter—6 percent of $2,000 for 90 days	29. 59
	Total	319. 24

If, in the above example, the taxpayer had prepaid only $1,000 by the first installment date instead of $5,000, and had subsequently paid the difference of $4,000 during the taxable year, a charge of 6 percent on this $4,000 would be imposed for the period the $4,000 remained unpaid.

However, subsection (d) of the House bill provides that no additional charge shall be applied with respect to any installment where the taxpayer establishes that the total amount of tax paid by that date is not less than an amount based on—

(*a*) The previous year's tax; or

(*b*) A tax based on the previous year's income, computed at current rates and current exemptions; or

(*c*) 70 percent (66⅔ percent in the case of farmers) of the tax computed on the actual income of the months of the taxable year preceding the installment date placed on an annual basis in a manner corresponding to that provided by section 47 (c) (1) of existing law.

These provisions are included in subsection (d) of the bill reported by your committee. A substantive change has been made by your committee to further provide that no additional charge shall be applied with respect to any installment where the total amount of tax paid by the installment date is not less than an amount based on 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the months in the taxable year ending before the month in which the installment is required to be paid (as if such months constituted a taxable year).

New subsection (e) added by your committee provides that for the purposes of this section the estimated tax shall be computed without any reduction for the amount which the taxpayer estimates as his credit under section 31 (relating to tax withheld at source on wages). Subsection (e) further provides that for the purposes of this section the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each installment date (determined under sec. 6153) for such taxable year. However, if the taxpayer establishes the dates on which all amounts were actually withheld, the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

Subsection (f), as amended by your committee, provides that the term "tax," for the purposes of subsections (b) (amount of underpayment) and (d), means the tax imposed by chapter 1 reduced by the credits against tax allowed by part IV of subchapter A of chapter 1 other than the credit against tax provided by section 31 (relating to tax withheld on wages).

New subsection (g) added by your committee provides that the application of this section to taxable years of less than 12 months shall be only in such manner as may be prescribed by regulations.

For purposes of applying this section in any case in which the taxable year of a partnership ends with or within the taxable year of a partner, the facts as to the partnership income for the months of the partnership year prior to the partner's installment date and as to the partner's distributive share of such income shall be taken into account in determining the partner's income for the months before such installment date.

The 6 percent per annum charge provided for in this section is a penalty addition to the tax and cannot be claimed or used as a deductible expense item in the determination of taxable income or of tax liability.

Section 145 of existing law makes it a crime to willfully fail to file a declaration of estimated tax. In section 7203 there is no penalty for failure to file a declaration. The penalty provided by section 7203 for willful failure to pay estimated tax is not changed from existing law.

For a discussion of the other features of the estimated tax payable by individuals, see the explanation under sections 6015, 6073, and 6153 of this report.

Section 6655. Failure by corporation to pay estimated income tax

This section is new and has no counterpart in existing law. This section corresponds to that of the House bill except for clarifying and conforming changes and for two changes described below.

Subsections (a), (b), and (c) of the House bill and of the bill reported by your committee provide, in case of failure to comply with the provisions relating to the payment of estimated income tax by a corporation, for a single charge of 6 percent per annum, computed for each installment date on the difference between the amount paid and 70 percent of the amount which should have been paid. The penalty charge would run until the amount is paid or until the filing date for the tax return, whichever is earlier.

However, subsection (d) of the House bill provides that no charge under this section shall be applied with respect to any installment where the corporation establishes that the total amount of tax paid on or before the last date prescribed for the payment of such installment is not less than an amount based on—

(*a*) The previous year's tax; or

(*b*) A tax based on the previous year's income, computed at current rates; or

(*c*) 70 percent of the tax computed with reference to the actual taxable income of the months of the taxable year preceding the installment date, which income is placed on an annual basis in a manner corresponding to that provided by section 47 (c) (1) of existing law.

A substantive change made by your committee relates to the provision for the computation of the tax on an annualized basis by reference to the months in the taxable year before the installment date. Your committee has retained the provisions of the House bill, but has further provided that the income to be annualized may be either that for the months immediately preceding the month of the installment date, or for a period ending 2 months earlier, whichever will result in no charge being made. Subsection (d) (3) as amended permits, for example, a calendar-year corporation to base its estimated income tax due on September 15, on the annualization of its taxable income through either June or August, and to base its estimated income tax due on December 15, on the annualization of its taxable income through either September or November. This change similarly applies to fiscal-year corporations.

The 3 tax computations referred to in the exception provisions of subsection (d), as amended, are each determined after subtracting the $100,000 exemption and after giving effect to the applicable credits against tax. For such purpose, if the previous year's tax is used, the applicable credits are those allowed for the previous year. If the previous year's income is used, the applicable credits are determined on the basis of such income and under the law applicable to the previous year, except that the rate used in determining the amount of the credit is the rate applicable to the current taxable year. If the income for the current year, placed on an annual basis, is used, the rates applicable to the current taxable year are used.

New subsection (f) added by your committee provides that the application of this section to taxable years of less than 12 months shall be only in such manner as may be prescribed by regulations.

The 6 percent per annum charge provided for in this section is a penalty addition to the tax and cannot be claimed or used as a deductible expense item in the determination of taxable income or of tax liability.

Section 145 of existing law makes it a crime to willfully fail to file a declaration of estimated tax. In section 7203 there is no penalty for failure to file a declaration. The penalty provided by section 7203 for willful failure to pay estimated tax is not changed from existing law.

For a discussion of the other features of the estimated tax payable by corporations, see the explanation under sections 6016, 6074, and 6154 of this report.

Section 6656. Failure to make deposit of taxes

This section is identical with that of the House bill.

This section imposes a penalty for the failure, without reasonable cause, to comply with the depositary receipt system. Depositary receipts are an important part of the collection procedures with respect to certain employment and excise taxes. The penalty provided by this section is 1 percent of the amount of the underpayment of the deposit for each month or part of a month during which the underpayment continues, but not to exceed 6 percent in the aggregate. The penalty will not be imposed for any period after the due date of the return with respect to which the deposit is required to be made. Under a system of quarterly returns with monthly deposits the maximum penalty will not exceed 3 percent, but under an annual return system with monthly deposits the penalty could reach 6 percent in some cases.

Section 6657. Bad checks

This section is identical with that of the House bill.

This section is a new provision which provides a specific penalty for giving the Internal Revenue Service a bad check in payment of any amount receivable under this title. The penalty will apply to checks which may be accepted in payment of taxes under existing law and also to personal checks which may be accepted in payment for stamps under the changes in the law made by this bill. The penalty does not apply if the person tendered the check in good faith and with reasonable cause to believe that it would be paid upon presentment.

Section 6658. Addition to tax in case of jeopardy

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6659. Applicable rules

This section is identical with that of the House bill.

This section provides that the additions to the tax, additional amounts, and penalties provided by chapter 68 shall be assessed, collected, and paid in the same manner as taxes, except where otherwise specifically provided in another section of this title. This conforms to the rules under existing law. By virtue of this section, it is unnecessary in other parts of the title to specifically refer to these additions to the tax when providing rules as to collection, assessment, etc., of taxes. This section also makes clear that the procedures for the assessment of deficiencies in income, estate, and gift taxes (including 90-day letters and appeal to the Tax Court) also apply to additions to those taxes.

Section 6671. Rules for application of assessable penalties

This section, which is identical to that of the House bill, contains no material change from existing law.

Section 6672. Failure to collect and pay over tax, or attempt to evade or defeat tax

This section is identical with that of the House bill.

This section is similar to certain sections of existing law which prescribe a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over, in the case of willful failure to collect, or to truthfully account for and pay over, any tax imposed by this title, or willful attempt in any manner to evade or defeat such tax. However, the application of this penalty is limited only to the collected or withheld taxes which are imposed on some person other than the person who is required to collect, account for and pay over, the tax. Under existing law this penalty is not applicable in any case in which the additions to the tax in the case of delinquency or fraud are applicable. Under this section the additions to the tax provided by section 6653, relating to negligence or fraud, shall not be applied for any offense to which this section is applicable.

Section 6673. Damages assessable for instituting proceedings before the Tax Court merely for delay

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6674. Fraudulent statement or failure to furnish statement to employee

This section, which is identical with that of the House bill, contains no material change from existing law.

Chapter 69—General Provisions Relating to Stamps

Section 6801. Authority for establishment, alteration, and distribution

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6802. Supply and distribution

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6803. Accounting and safeguarding

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6804. Attachment and cancellation

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6805. Redemption of stamps

This section is identical with that of the House bill.

Under existing law, the period of limitation for redemption of stamps is 4 years. This section changes this period to 3 years. As so changed, this period corresponds to the period of limitation provided for refund of overpayments.

Section 6806. Posting occupational tax stamps

This section is identical with that of the House bill.

Under existing law, the stamps denoting payment of the tax on coin-operated amusement and gaming devices are required to be posted in the operator's place of business. This section gives the Secretary authority to require by regulations that the stamp be posted on each such amusement or gaming device in such a manner that it will be visible to any person operating the device.

Section 6807. Stamping, marking, and branding seized goods

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6808. Special provisions relating to stamps

This section, which is identical with that of the House bill, contains references to special provisions relating to stamps.

CHAPTER 70—JEOPARDY, BANKRUPTCY, AND RECEIVERSHIPS

Section 6851. Termination of taxable year

This section is identical with that of the House bill and, except for subsection (b), contains no material change from existing law.

Subsection (b) is a new provision which permits the taxable year, once closed by the Secretary, to be reopened. Subsection (b) will apply, for example, in the case of an alien who departs from and returns to the United States within the 12-month period which would otherwise be his taxable year. Under existing law, such a taxpayer would have more than 1 taxable year in the same 12-month period. This section provides that the taxable year shall be reopened if the taxpayer files a true and accurate return of his items of gross income, deductions, and credits, together with such other information as may be required by regulations.

Section 6861. Jeopardy assessment of income, estate, and gift taxes

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 6862. Jeopardy assessment of taxes other than income, estate, and gift taxes

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 6863. Stay of collection of jeopardy assessments

This section corresponds to that of the House bill except for a substantive change in subsection (a) and the addition of a new provision in subsection (b). This section of the House bill contained no material change from existing law.

Your committee has amended subsection (a) of this section to provide that the amount of the bond required to stay collection of a jeopardy assessment shall be equal to the amount of the tax, including any additions thereto, collection of which is sought to be stayed. Under existing law the amount of the bond could be as much as twice the amount of the tax in question.

Paragraph (3) of subsection (b), which has no counterpart in the House bill, provides for the stay of sale of property seized under a jeopardy assessment until the decision of the Tax Court has become final or, if no petition is filed with the Tax Court, until the expiration of the time provided in section 6213 for filing such petition. This provision will not be applicable, however, if the taxpayer consents to the sale, or if the Secretary or his delegate determines that the expenses of conservation and maintenance of the property so seized will greatly reduce the net proceeds, or if the property is (or at any time after seizure becomes) property of the type described in section 6336, relating to property which is liable to perish or become greatly reduced in price or value by keeping, or which cannot be kept without great expense. This paragraph will apply to all jeopardy assessments made on or after January 1, 1955, whether made with respect to taxes imposed under the Internal Revenue Code of 1939 or the Internal Revenue Code of 1954.

Section 6864. Termination of extended period for payment in case of carryback

This section, which is identical with that of the House bill, contains a reference to the provision relating to the termination of extensions of time for payment of income tax of a corporation expecting a carryback in case of jeopardy.

Section 6871. Claims for income, estate, and gift taxes in bankruptcy and receivership proceedings

This section is identical with that of the House bill.

Sections 274 and 1015, relating to income and gift taxes, provide that in the case of bankruptcy and receivership proceedings the unpaid taxes shall be immediately assessed, and provide that claim therefor may be presented for adjudication in the proceeding. This section makes a more modern reference to the bankruptcy and receivership proceedings to which these rules are applicable, and extends these provisions to cover estate taxes.

Section 6872. Suspension of period on assessment

This section is identical with that of the House bill.

This section, which corresponds to section 274 (a) of the existing income tax law, provides for the suspension of the period of limitations on assessment of any unpaid tax during any proceeding under the Bankruptcy Act or other court proceeding where the fiduciary or receiver is required to give notice to the Internal Revenue Service of his appointment. As under section 274, the suspension is for the period from the date of the institution of the proceeding to a date 30 days after the receipt of the notice by the Secretary but the suspension may not exceed 2 years.

Section 6873. Unpaid claims

This section is identical with that of the House bill.

This section, which corresponds to sections 274 and 1015 of existing law, relating to the income and gift taxes, requires any unpaid portion of a claim for any tax allowed in the receivership or Bankruptcy Act proceeding to be paid on notice and demand. It conforms to section 6872, discussed above. For the period of limitations applicable to such claim, see section 6503 (b).

Chapter 71—Transferees and Fiduciaries

Section 6901. Transferred assets

This section corresponds to that of the House bill except for a conforming amendment and a clarifying amendment. This section except as noted below corresponds to existing law in the case of income, estate, and gift taxes. This section also permits the assessment of the liability of a transferee for taxes other than income, estate and gift taxes if the transferee liability arises from the liquidation of a partnership or a corporation or a reorganization within the meaning of section 368 (a).

With respect to the period of limitation on assessment of transferee liability, existing provisions of the income-tax law have been made applicable to estate and gift taxes and to the new cases in which transferee liability may be assessed for other taxes. The period of limitation in the existing estate and gift tax law differs from the income tax law in the case of a transferee of a transferee. Under this section, as under existing income tax law, the assessment must be made within 1 year after the expiration of the period of limitation for assessment against the preceding transferee but not more than 3 years after the expiration of the period of limitation for assessment against the initial transferor. This is subject to an exception in the case of a court proceeding against the initial transferor or the last preceding transferee; the period of limitation in such case expires 1 year after the return of execution in the court proceeding.

The House bill provided in subsection (d) (1) that, if a transferee or fiduciary agreed to an extension of the period for assessment, the period for filing claim for credit or refund of tax paid by him is also extended for the period of the agreement and 6 months thereafter. Your committee has amended subsection (d) (1) to provide that where the statute of limitations is extended for an overpayment made by the transferee or fiduciary it will be extended for a like period with respect to an overpayment made by the transferor in those cases where the transferee or fiduciary is legally entitled to credit or refund of the overpayment. The amendment does not change any substantive rights but merely extends the statute of limitations in those cases where the transferee or fiduciary has a legal right under existing law to credit or refund of the overpayment of the transferor.

In the case of such an agreement, section 6511 (c) limits the amount of any credit or refund to the amount of tax paid within a period of time specified in such section.

Subsection (d) (2) of this section relating to the amount of the credit or refund provides that the period within which amounts paid may be credited or refunded shall be increased in any case where the transferee agrees to extend the time for assessment, and such agreement is made after the period for assessment against the taxpayer has expired. In such case, the period prescribed in section 6511 (b) (2) is increased by the period which elapsed between the date of expiration of the period for assessment against the taxpayer and the date of the agreement.

Section 6902. Provisions of special application to transferees

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 6903. Notice of fiduciary relationship

This section is identical with that of the House bill. The section imposes a duty upon the fiduciary to act for the taxpayer whom he represents or for the estate for which he is responsible. Under existing law, the fiduciary is responsible taxwise for such persons in the case of income, estate, and gift taxes. This section extends this rule to all taxes.

Section 6904. Prohibition of injunctions

This section, which is identical with that of the House bill, contains a reference to the provision relating to the prohibition of suits to restrain enforcement of the liability of a transferee or a fiduciary.

CHAPTER 72—LICENSING AND REGISTRATION

Section 7001. Collection of foreign items

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7011. Registration—Persons paying a special tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7012. Cross references

This section is identical with that of the House bill.

The cross references contained in this section relate to registration and penalties for failure to register in certain supervised industries.

CHAPTER 73—BONDS

Section 7101. Form of bonds

This section, which is identical with that of the House bill, contains no material change from existing law. It merely incorporates, in one place a rule corresponding to the rules usually provided in existing law in each section which refers to a security or bond.

Section 7102. Single bond in lieu of multiple bonds

This section is identical with that of the House bill. The section provides a general rule (which supersedes existing section 3676) to the effect that wherever 2 or more bonds are required, the Secretary may accept 1 bond instead of the several bonds otherwise required. Existing code section 3676 permits a single bond in place of 2 bonds where there is an extension of time to pay a deficiency and also a release of a lien.

Section 7103. Cross references—other provisions for bonds

This section, which is identical with that of the House bill, contains references to provisions relating to bonds.

CHAPTER 74—CLOSING AGREEMENTS AND COMPROMISES

Section 7121. Closing agreements

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 7122. Compromises

This section is identical with that of the House bill.

This section makes no material change from section 3761 of the 1939 Code, except that no legal opinion is required with respect to the compromise by the Secretary or his delegate of a civil case in which the unpaid amount of tax assessed (plus any interest, additional amount, addition to the tax, or assessable penalty) is less than $500.

Section 7123. Cross references

This section is identical with that of the House bill.

This section contains references to criminal penalties relating to compromises and closing agreements, and to provisions relating to compromises after judgment.

CHAPTER 75—CRIMES, OTHER OFFENSES, AND FORFEITURES

Section 7201. Attempt to evade or defeat tax

This section corresponds to that of the House bill except for a substantive change noted below.

This section makes it a felony punishable by fine of not more than $10,000, or imprisonment of not more than 5 years, or both, to attempt in any manner to evade or defeat any tax imposed by this title or the payment thereof. This section corresponds to numerous sections in existing law covering this offense.

Under existing law, it is a misdemeanor (with maximum punishment of $10,000 fine and 1 year imprisonment) willfully to fail to make a return at the time required by law or regulations. Under the House bill, this rule is continued in section 7203 as to returns other than tax returns, but makes this offense in the case of tax returns (that is, any return required under authority of part II of subchapter A of chapter 61) punishable to the same extent as an attempt to defeat or evade the tax.

The bill as reported by your committee amends this section and section 7203 so as to continue in effect the existing law with respect to the nature of, and the punishment for, the offense of a willful failure to make a tax return. Under these amendments, section 7201 will apply only to a willful attempt in any manner to evade or defeat the tax or the payment thereof, and the lesser offense of a willful failure to file a tax return will be punishable as a misdemeanor under section 7203.

Section 7202. Willful failure to collect or pay over tax

This section is identical with that of the House bill.

This section provides that, in the case of any tax imposed by this title which any person must collect and pay over to the United States, it is a felony punishable by a fine of not more than $10,000, or imprisonment for not more than 5 years, or both, willfully to fail to collect or truthfully account for and pay over such tax. This provision corresponds to numerous sections of existing law which cover this offense.

Section 7203. Willful failure to file a return, supply information, or pay tax

This section corresponds to that of the House bill, except for a substantive change noted below.

This section provides that it is a misdemeanor, punishable by a fine of not more than $10,000, or imprisonment for not more than 1 year, or both, to willfully fail to pay any tax (including any estimated tax referred to sec. 6153 or 6154), make any return, keep any records, or supply any information at the time or times required by law or regulations. It corresponds to numerous sections of existing law, including those applicable to the income, estate, gift, and excise taxes. However, under the House bill, the section differed from existing law in that it did not apply to tax returns required under part II of subchapter A of chapter 61.

The bill as reported by your committee amends this section to include as a misdemeanor the willful failure to make a tax return at the time required by law or regulation, other than a declaration of estimated tax required under authority of section 6015 or 6016.

See also discussion in the explanation of section 7201.

Section 7204. Fraudulent statement or failure to make statement to employees

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 7205. Fraudulent withholding exemption certificate or failure to supply information

This section, which is identical with that of the House bill, contains no material change in existing law.

Section 7206. Fraud and false statements

This section corresponds to that of the House bill except for a substantive change noted below.

The section collects in one place and makes generally applicable to taxes imposed by this title the various penal provisions in existing law relating to fraud and false statements. This section of the House bill provides that the offenses described therein shall be punished by a fine of not more than $10,000, or by imprisonment for not more than 5 years, or both.

Your committee has amended the provisions in the House bill to reduce the penalty to a fine of not more than $5,000, or imprisonment for not more than 3 years, or both.

The first offense described in this section is that of making a false declaration under penalty of perjury. This offense corresponds to the offense described in section 3809 (a) of the 1939 Code. The penalty provided by section 3809 (a) is a fine of not more than $2,000, or not more than 5 years imprisonment, or both.

The second offense relates to willfully aiding or assisting in the preparation or presentation of any return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter. This offense corresponds to the offense described in section 3793 (b) of the 1939 Code. The penalty imposed by this section is the same as that imposed by section 3793 (b) of the 1939 Code.

The third offense corresponds to the offense described in section 3793 (a) of the 1939 Code, which relates to simulating or falsely or fraudulently executing or signing any bond, permit, entry or other document required by the internal revenue laws or procuring the same to be done. Existing law imposes no fine for this offense but provides that imprisonment for the offense shall not be less than 1 year nor more than 5 years.

The fourth offense relates to the offense of removing, depositing or concealing property in respect of which any tax is imposed, or upon which levy is authorized, with intent to evade or defeat the assessment or collection of any tax imposed by this title. This section differs from section 3321 (a) of the 1939 Code in that this section covers such offenses committed in order to avoid levy, and in that the punishment under section 3321 (a) is a fine of not more than $5,000, or imprisonment for not more than 3 years, or both.

The fifth offense corresponds to the offense described in section 3762 of the 1939 Code, that is, the offense of concealing property or withholding, falsifying, or destroying records, or making any false statement in connection with any compromise, offer of compromise, closing agreement or offer to enter into a closing agreement. The punishment under section 3762 is a fine of not more than $10,000, or not more than 1 year imprisonment, or both.

Section 7207. Fraudulent returns, statements, or other documents

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7208. Offenses relating to stamps

This section is identical with that of the House bill.

The section brings together, and makes applicable to all taxes collected by stamps, various offenses described in existing law relating to stamps. These offenses correspond to the acts, described in sections 7201 and 7206, of fraud on the revenue or of attempting to defeat or evade the tax or the payment of tax. The same punishment is prescribed in this section as in sections 7201 and 7206, namely, fine of not more than $10,000, or imprisonment not more than 5 years, or both.

Existing provisions of law to which this section corresponds, except for the changes noted below, are as follows:

(a) Counterfeiting, which offense is described specifically in section 1425 (b) of the 1939 Code, relating to employment taxes. Section 1425 (b) provides for a fine of not more than $5,000, or imprisonment for not more than 5 years, or both.

(b) Mutilation or removal of stamps, which offense is described in section 1823 (a) of the 1939 Code. That section provides a fine of not more than $1,000, or imprisonment for not more than 5 years, or both.

(c) Use of mutilated, insufficient or counterfeited stamps, which offense is described in section 1823 (b) of the 1939 code. The punishment under section 1823 (b) is the same as under section 1823 (a), described in (b) above.

(d) Reuse of stamps, which offense is described in section 1823 (c) of the 1939 Code, and which is subject to the same penalty as that described under (b) and (c) above.

(e) Offenses relating to the disposal or receipt of emptied stamped packages, which offenses are described in section 3323 (a) (3) of the 1939 Code. Under section 3323 (a) (3) the offense carries a minimum punishment of $1,000 fine or 6 months imprisonment, and a maximum punishment of $5,000 fine or 5 years imprisonment, or both such fine and imprisonment.

Section 7209. Unauthorized use or sale of stamps

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7210. Failure to obey summons

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7211. False statements to purchasers or lessees relating to tax

This section, which corresponds to that of the House bill except for a clerical amendment, contains no change from existing law.

Section 7212. Attempts to interfere with administration of internal revenue laws

This section corresponds to that of the House bill except for a substantive change in subsection (a). In subsection (a) the House bill provided that any of the offenses described therein are to be punishable by a fine of not more than $5,000, or by imprisonment for not more than 3 years, or both. The substantive change made by your committee amends subsection (a) by defining threats of force as meaning threats of bodily harm to the officer or employee of the United States or to a member of his family, and by providing that if the offense is committed only by threats of force it is to be punishable by a fine of not more than $3,000, or imprisonment for not more than 1 year, or both.

Subsection (a) of this section, relating to the intimidation or impeding of any officer or employee of the United States acting in an official capacity under this title, or by force or threat of force attempting to obstruct or impede the due administration of this title is new in part. This section provides for the punishment of threats or threatening acts against agents of the Internal Revenue Service, or any other officer or employee of the United States, or members of the families of such persons, on account of the performance by such agents or officers or employees of their official duties. This section will also punish the corrupt solicitation of an internal revenue employee.

Subsection (a) of this section is broader than section 111 of title 18 of the United States Code, relating to persons assaulting, resisting, or impeding certain officers or employees of the United States while engaged in the performance of their official duties, in that it covers threats of force (including any threatening letter or communication) or corrupt solicitation.

Subsection (b) of this section, relating to forcible rescue of seized property, makes no material change from existing law.

Section 7213. Unauthorized disclosure of information

This section is identical with that of the House bill.

The section contains no material change from existing law except that the offense by State employees of disclosing information obtained under section 6103 has been restated in order to cover additional acts of disclosure which are now offenses in the case of Federal employees.

Section 7214. Offenses by officers and employees of the United States

This section is identical with that of the House bill.

Subsection (a) of this section corresponds, with certain changes, to the provisions of section 4047 (e) of the 1939 code. The first change is that this section will apply to any officer or *employee* of the United States acting in connection with any revenue law of the United States. Section 4047 (e) applies to any officer or *agent* appointed and acting under the authority of any revenue law of the United States. Section 4047 (e) (3) describes, as an offense, the willful neglect to perform any of the duties enjoined on the officer or agent by law. The corresponding provision of this section changes existing law to make it applicable only if the employee "with intent to defeat the application of any provision of this title, fails to perform any of the duties of his office or employment." This change makes the offense one involving misapplication of the revenue laws, as distinguished from the mere negligent or other improper conduct of an employee, not involving criminal intent, which could continue to be handled (as under existing law in the case of employees not covered by sec. 4047 (e)) by reprimand or dismissal or other action under the civil service laws. Section 4047 (e) (5) makes it an offense to make opportunity for any person to defraud the United States. The corresponding provision of this section makes it an offense to knowingly make opportunity for any person to defraud the United States. Paragraph (a) (7) of this section corresponds to existing paragraph (8) of section 4047 (e), except in two respects. Existing law refers to a false entry in any book or the making of any false certificate or return. This section changes the word "false" to "fraudulent" to avoid the implication that this provision would apply to an innocent making of a false entry. This section also expands existing law to cover not only a "certificate" or "return" but also a "statement," and to eliminate the limitation of existing law that the penalty applies only where the employee is required to make the entry, certificate, or return. Under section 7214 he is subject to punishment in any case where he makes a fraudulent statement, whether or not he is required to make the statement. Paragraph (a) (8) of this section corresponds to existing paragraph (9) of section 4047 (e), except in one respect. Existing law requires the officer or agent to report to his next superior officer and to the Commissioner. This section strikes the requirement that he report to his next superior officer, and leaves the requirement that he shall report to the Secretary or his delegate. Thus, section 7214 avoids the possibility of the employee being required to report to his next superior officer any fraud or violation which he believes was committed by that officer. Such reports instead will be made to such office, for example, the internal revenue inspection service, as the Secretary or his delegate may designate.

Subsection (b) of this section is in all material respects the same as section 4047 (b) of the 1939 Code, except that the provisions thereof are made applicable to any internal-revenue officer or employee instead of, as provided under existing law, to any internal-revenue officer or internal-revenue agent.

Section 7231. Failure to obtain license for collection of foreign items

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7232. Failure to register or give bond, or false statement by manufacturer or producer of gasoline or lubricating oil

This section corresponds to that of the House bill except for one amendment. In this section of the House bill the maximum fine under existing law of $5,000 was increased to $10,000. Your committee has restored the maximum fine of $5,000, and, as amended, this section contains no material change from existing law.

Section 7233. Failure to pay, or attempt to evade payment of, tax on cotton futures, and other violations

This section, which corresponds to that of the House bill except for a clerical amendment, contains no material change from existing law.

Section 7234. Violation of laws relating to oleomargarine or adulterated butter operations

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7235. Violation of laws relating to adulterated butter and process or renovated butter

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7236. Violation of laws relating to filled cheese

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7237. Violation of laws relating to narcotic drugs and to marihuana

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7238. Violation of laws relating to opium for smoking

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7239. Violations of laws relating to white phosphorus matches

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7240. Officials investing or speculating in sugar

The section is identical with that of the House bill.

This section contains no material change from existing law, except that a provision has been added (corresponding to section 7214) that the official committing the offense shall be dismissed from office or discharged from employment.

Section 7261. Representation that retailers' excise tax is excluded from price of article

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7262. Violation of occupational tax laws relating to wagering—failure to pay special tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7263. Penalties relating to cotton futures

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7264. Offenses relating to renovated or adulterated butter

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7265. Other offenses relating to oleomargarine or adulterated butter operations

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7266. Offenses relating to filled cheese

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7267. Offenses relating to white phosphorus matches

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7268. Possession with intent to sell in fraud of law or to evade tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7269. Failure to produce records

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7270. Insurance policies

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7271. Penalties for offenses relating to stamps

This section is identical with that of the House bill.

The section contains no material change from existing law, except that the penalty provided by this section is $50 for each such offense. The corresponding provisions of existing law provide various different amounts, such as $100 in sections 1820 and 1822, $50 to $500 in section 3323 (a), etc.

Section 7272. Penalty for failure to register

This section is identical with that of the House bill.

The section contains no material change from existing law, except that the penalty in existing law for failure to register as a manufacturer of white phosphorus matches is reduced from $500 to $50.

Section 7273. Penalties for offenses relating to special taxes

This section is identical with that of the House bill.

The section contains no material change from existing law, except that the reference to costs of prosecution found in existing law has been eliminated.

Section 7274. Penalty for offenses relating to white phosphorus matches

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7275. Failure to print correct price on tickets

This section, which is identical with that of the House bill, contains a reference to the penalty provision applicable to certain offenses relating to admission taxes.

Section 7301. Property subject to tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7302. Property used in violation of internal revenue laws

This section is identical with that of the House bill.

The section contains no material change from existing law. The language of the section has been changed slightly in order to make clear that its provisions have general application under this title.

Section 7303. Other property subject to forfeiture

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7304. Penalty for fraudently claiming drawback

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7321. Authority to seize property subject to forfeiture

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7322. Delivery of seized personal property to United States marshal

This section, which corresponds to that of the House bill except for a clerical amendment, contains no material change from existing law.

Section 7323. Judicial action to enforce forfeiture

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7324. Special disposition of perishable goods

This section is identical with that of the House bill.

The section contains no material change from existing law, except that it provides that, where bond is not filed, the sale shall be public sale in such manner as may be prescribed by regulations. Under existing law, the property must be sold at public auction in the same manner as goods may be sold on final execution in the district.

Section 7325. Personal property valued at $1,000 or less

This section is identical with that of the House bill.

The section makes several changes in existing law. The first change extends the application of the section to property valued at $1,000 or less, in lieu of the $500 amount provided by section 3724 of the 1939 Code. The second change is the provision that the Secretary shall by regulations prescribe the reasonable compensation to be allowed the appraisers of the property, instead of the existing provision of law which states that they shall be allowed the sum of $1.50 a day. This section also changes existing law to permit the property to be disposed of by sale upon competitive bids in such manner as may be prescribed by regulations.

Section 7326. Disposal of forfeited or abandoned property in special cases

This section, which is identical with that of the House bill, contains a reference to provisions relating to disposal of forfeited narcotic drugs and firearms.

Section 7327. Customs laws applicable

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7328. Confiscation of matches exported

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7329. Cross references

This section is identical with that of the House bill.

This section contains references to provisions relating to forfeitures generally in connection with taxes with respect to alcohol, tobacco, and certain firearms, and for the issuance of certificates to relieve officers making seizures of responsibility for damages.

Section 7341. Penalty for sale to evade tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7342. Penalty for refusal to permit entry or examination

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7343. Definition of term "person"

This section is identical with that of the House bill.

The section continues in one place the provision now found in the various criminal provisions of the existing Internal Revenue Code.

Section 7344. Extended application of penalties relating to officers of the Treasury Department

This section, which is identical with that of the House bill, contains no material change from existing law.

CHAPTER 76—JUDICIAL PROCEEDINGS

Section 7401. Authorization

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7402. Jurisdiction of district courts

This section, except for the insertion of a cross reference, corresponds to that of the House bill and contains no material change from existing law, except that subsection (c) is applicable to any officer or employee of the United States, or persons acting under or by authority of such officer or employee, acting under the authority of this title. The corresponding provision of existing law applies only to internal-revenue officers or persons acting under or by authority of any such officer.

Section 7403. Action to enforce lien or to subject property to payment of tax

This section corresponds to that of the House bill except for one amendment, and as amended, contains no material change from existing law. Your committee's amendment strikes from subsection (e) of the House bill a specific provision that the assessment of the tax upon which the lien of the United States is based shall be conclusively presumed to be valid for purposes of the adjudication in an action to enforce the lien of the United States or to subject property of the delinquent taxpayer to the payment of the tax. The elimination of this provision is not designed to change the effect under existing law given to the assessment in such an adjudication.

Section 7404. Authority to bring civil action for estate taxes

This section corresponds to that of the House bill except for a clarifying change. It contains no material change from existing law. The clarifying change eliminates references to unnecessary sections.

Section 7405. Action for recovery of erroneous refunds

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7406. Disposition of judgments and moneys recovered

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7407. Cross references

This section is identical with that of the House bill.

This section contains references to the general provisions of law relating to venue in civil actions and collection of taxes.

Section 7421. Prohibition of suits to restrain assessment or collection

This section, which is identical with that of the House bill, contains no material change in existing law, except that subsection (b) is extended to conform to the extended authority, in section 6901 (a) (2), to assess transferee liability.

Section 7422. Civil actions for refund

This section corresponds to that of the House bill except for a change in subsection (c) and a change in subsection (e), both of which are described below.

Subsections (a) to (d), inclusive, of this section contain no material change from existing law. Subsection (c) of the House bill omitted the date June 15, 1942, which date has been restored by your committee's amendment.

Subsection (e) of this section is a new provision to cover the situation where there is concurrent jurisdiction in the district court (or Court of Claims) and in the Tax Court over the same case. This may arise, for example, where the taxpayer files suit for refund in the district court and, while the suit is pending, a notice of deficiency is issued and he appeals that notice to the Tax Court. Under subsection (e), if the notice of deficiency is issued before the case is heard in the district court (or Court of Claims), the proceeding must be stayed for the 90-day period of the notice and for 60 days thereafter. If the taxpayer appeals to the Tax Court then the district court (or the Court of Claims) shall lose jurisdiction over the refund. If the taxpayer does not appeal, the United States may then counterclaim in the taxpayer's suit, or intervene if this is a suit against the district director, even though the time for filing such counterclaim or petition for intervention may have otherwise expired, and upon such counterclaim or intervention the taxpayer will have the same burden of proof as he would bear if he had appealed the case to the Tax Court.

The result under subsection (e) is to give jurisdiction over the cause of action to only 1 court (2 courts may acquire jurisdiction under existing law), and to give the taxpayer the choice of which court shall have jurisdiction. The taxpayer, by filing a petition in the Tax Court, would cause that court to have sole jurisdiction, or, by failing to file a petition in the Tax Court, would cause the district court or the Court of Claims to have sole jurisdiction.

Subsection (e) does not apply if the case in the district court or Court of Claims has already proceeded to a hearing, that is, to actual trial. On the other hand, it will apply to prevent suit in the district court or Court of Claims after the receipt of a notice of deficiency in any case where the taxpayer appeals from that notice to the Tax Court.

Your committee has amended subsection (e) as contained in the House bill by providing that such subsection will not be effective with respect to any suit pending, instituted, or commenced before the enactment of this act.

Section 7423. Repayments to officers or employees

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7424. Civil action to clear title to property

This section, which is identical with that of the House bill, corresponds, with one change, to the provisions of subsections (a), (c), and (d) of section 3679 of the 1939 Code. Existing law refers only to realty, whereas this section covers both real and personal property. The provisions of subsection (b) of section 3679 of the 1939 Code, relating to service on the United States, have been eliminated from this bill as being unnecessary, since title 28 of the United States Code makes adequate provision for service on the United States.

Section 7425. Cross references

This section is identical with that of the House bill.

This section contains references to general provisions of law relating to bankruptcy actions and other civil actions.

Section 7441. Status

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7442. Jurisdiction

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7443. Membership

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7444. Organization

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7445. Offices

This section corresponds to that of the House bill and to the corresponding section of existing law except for one change. Your committee has deleted the second sentence of the House bill which would require the Secretary or his delegate to provide the Tax Court with suitable rooms while in session outside the District of Columbia. The deleted sentence is considered surplusage.

Section 7446. Times and places of sessions

This section, except that your committee has substituted the word "sessions" for "meetings", corresponds to that of the House bill and contains no material change from existing law.

Section 7447. Retirement

This section corresponds to that of the House bill except for clerical changes and for one substantive change. Your committee has amended subsection (c) of this section to provide that if a retired judge is recalled to duty he will during the period of his active duty receive the same compensation as is then being paid to other judges of the Tax Court and will not receive retirement pay for such period. Except for this amendment, the section contains no material change from existing law.

Section 7451. Fee for filing petition

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7452. Representation of parties

This section, which is identical with that of the House bill, provides that the Secretary or his delegate shall be represented by the Assistant General Counsel of the Treasury Department serving as Chief Counsel of the Internal Revenue Service, or the delegate of such Chief Counsel, in the same manner before the Tax Court as he has heretofore been represented in proceedings before such court. The section further provides that the taxpayer shall continue to be represented in accordance with the rules of practice prescribed by the court; and that no qualified person shall be denied admission to practice before the Tax Court because of his failure to be a member of any profession or calling.

Section 7453. Rules of practice, procedure, and evidence

This section is identical with that of the House bill.

Section 1111 of the 1939 Code requires the Tax Court to follow the rules of evidence applicable in the courts of the District of Columbia in the type of proceedings which prior to September 16, 1938, were within the jurisdiction of the courts of equity of the District. This section modernizes the requirement to provide that the Tax Court shall follow the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia.

Section 7454. Burden of proof in fraud and transferee cases

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7455. Service of process

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7456. Administration of oaths and procurement of testimony

This section corresponds to that contained in the House bill with one exception set out below. In the House bill subsections (a) and (c) of this section contain no material change from existing law, except that subsection (a) permits a subpoena to be signed by the clerk of the Tax Court whereas existing law requires that it be signed by a judge of the Tax Court. Your committee has amended subsection (a) to provide that the clerk of the Tax Court or his deputies may administer oaths without designation in writing by the chief judge.

Subsection (b) of this section is a new provision relating to the production of records in the case of foreign corporations, of foreign trusts or estates, and of nonresident alien individuals. It provides that if the Tax Court requires any petitioner which is a foreign corporation, foreign trust or estate, or nonresident alien individual, to produce in court any books or records which are relevant to the issues in the case, and which are in the possession or control of the petitioner or of any parent or subsidiary corporation or any other entity controlled by or controlling the petitioner, and if the required books or records are not produced or made available for inspection or copying, within a reasonable time, the Tax Court shall upon motion strike out the pleadings or parts thereof, or dismiss the proceedings or a part thereof, or render a judgment by default.

Section 7457. Witness fees

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7458. Hearings

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7459. Reports and decisions

This section, which corresponds to that of the House bill, except for a clerical change, contains no material change from existing law.

Section 7460. Provisions of special application to divisions

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7461. Publicity of proceedings

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7462. Publication of reports

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7463. Provisions of special application to transferees

This section, which is identical with that of the House bill, contains references to provisions of special application to transferees.

Section 7471. Employees

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7472. Expenditures

This section, which is identical with that of the House bill, differs from existing law only by providing that vouchers for expenditures by the court shall be signed by the certifying officer designated by the chief judge. Existing law requires the chief judge to sign such vouchers.

Section 7473. Disposition of fees

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7474. Fee for transcript of record

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7481. Date when Tax Court decision becomes final

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7482. Courts of review

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7483. Petition for review

This section corresponds to that of the House bill except for one change. The House bill changed existing law by providing, in case one party to the proceeding files a petition for review of a Tax Court decision, that the adverse party is given one additional month to file his petition for review. Your committee has amended the section to provide that if one party to the proceeding files a petition for review, the additional month to file a petition for review will be available to any other party to the proceeding, whether or not an adverse party.

Section 7484. Change of incumbent in office

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7485. Bond to stay assessment and collection

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7486. Refund, credit, or abatement of amounts disallowed

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7487. Cross reference

This section, which is identical with that of the House bill, contains a reference to the authority of the Tax Court to fix fees for transcripts of records.

Section 7491. Burden of proof of exemptions in the case of marihuana offenses

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7492. Enforceability of cotton futures contracts

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7493. Immunity of witnesses in cases relating to cotton futures

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7494. Venue in criminal prosecutions

This section has been eliminated by your committee. As contained in the House bill, this section, relating to venue in criminal prosecutions, would have applied in cases where the taxpayer resides in one judicial district while the internal revenue office where he is required to file his return, pay his tax, supply information, etc., is located in another judicial district. In such case, the taxpayer might use the United States mail to send the payment, return, or other document to the internal revenue office, and, if he deposited the matter in the United States mail in the judicial district of his residence, that act would have the same consequence for purpose of determining the venue as the payment of the tax or filing of the return or other document in an internal revenue office. Similarly, the venue would be determined as if any failure to do such act, or any concealment of property, or withholding, falsifying, or destroying records, occurred in the judicial district of his residence.

Chapter 77—Miscellaneous Provisions

Section 7501. Liability for taxes withheld or collected

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7502. Timely mailing treated as timely filing

This section corresponds to that of the House bill except for a clerical change. The section applies in the case where documents (other than returns) are mailed to the proper office within the time prescribed by the internal-revenue laws, as indicated by the postmark on the envelope, and are received by that office after such time has expired. In such case, the document is deemed timely filed.

Since it is possible to predate postmarks where mailing machines or other devices are used, subsection (b) provides that a postmark not made by the United States post office shall be deemed the date of delivery only to the extent permitted by regulations. If the document is sent by registered mail rather than ordinary mail, the registration before the due date is prima facie evidence that the document was delivered to the proper officer, and the date of registration is deemed the date of mailing.

This section does not apply to the filing of a document in any court other than the Tax Court. As used in this section, the term "document" includes a petition to the Tax Court.

Section 7503. Time for performance of acts where last day falls on Saturday, Sunday, or legal holiday

This section corresponds to that of the House bill except for one change described below. As contained in the House bill this section provides that if any act required under the internal revenue laws is required to be performed on a Saturday, Sunday, or legal holiday, the performance of the act on the next succeeding workday will be deemed timely. It defines a legal holiday as meaning not only a legal holiday in the District of Columbia but also, in the case of any document required to be filed or any other act required to be performed at any office of the United States located outside the District of Columbia, but within an internal revenue district, a legal holiday at the place where such office is located.

Your committee has amended this section so that the term "legal holiday" will include, in addition to a legal holiday in the District of Columbia, only those holidays provided by State law which are applicable to the entire State in which the document is required to be filed or the act is required to be performed.

This section will apply, for example, in determining whether a claim for refund is timely filed or suit for refund is timely instituted, and in determining whether an assessment is timely made or suit for collection without assessment is timely instituted.

Section 7504. Fractional parts of a dollar

This section, which is identical with that of the House bill, permits the Secretary to round to the nearest dollar any assessment of a deficiency or underpayment, and similarly to round to the nearest dollar any amount he allows as a credit or refund.

Section 7505. Sale of personal property purchased by the United States

This section, which is identical with that of the House bill, corresponds to section 3695 (b) and (c) of the 1939 Code, changes existing law to eliminate the concept that sale of personal property previously purchased by the United States must be made within the district where the original levy was made.

Section 7506. Administration of real estate acquired by the United States

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7507. Exemption of insolvent banks from tax

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7508. Time for performing certain acts postponed by reason of war

This section, which is identical with that of the House bill, contains no material change in existing law. It continues in the law those provisions of section 3804 of the 1939 Code which are made necessary by reason of the continued application of subsection (f) of that section.

Section 7509. Expenditures incurred by the Post Office Department

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7510. Exemption from tax on domestic goods purchased for the United States

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7511. Exemption of consular officers and employees of foreign states from payment of internal revenue taxes on imported articles

This section, for which there is no corresponding section in the House bill, is derived from section 3802 of the Internal Revenue Code of 1939. This section contains no material change from existing law and, since it merely continues in effect the provisions of section 3802, it is subject to the same modifications as may be applicable to section 3802 by reason of legislation, enacted subsequent to the enactment of section 3802, relating to alien immigrants with nonresident status.

Chapter 78—Discovery of Liability and Enforcement of Title

Section 7601. Canvass of districts for taxable persons and objects

This section, which is identical with that of the House bill, contains no material changes from existing law.

Section 7602. Examination of books and witnesses

This section corresponds to that of the House bill except for a technical amendment and, as amended, contains no material change from existing law.

Section 7603. Service of summons

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7604. Enforcement of summons

This section is identical with that of the House bill.

The section contains no material change from existing law, except that it refers to the district in which the person summoned "resides or is found," whereas existing law refers only to the district in which he "resides."

Section 7605. Time and place of examination

This section is identical with that of the House bill.

The section gives the Secretary authority to fix such time and place for the examination as are reasonable under the circumstances, but when appearance and production of books and records under summons is required, the date fixed for appearance may not be less than 10 days after the issuance of such summons. This provision supersedes the provision in section 3615 (d) of the 1939 Code which provides that when a summons is served the person summoned must be allowed 1 day for each 25 miles he may be required to travel, computed from the place of service to the place of examination.

Section 7606. Entry of premises for examination of taxable objects

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7607. Cross references

This section is identical with that of the House bill.

This section contains references to provisions relating to inspection of books, papers, records, or other data of certain special taxpayers, and to provisions relating to search warrants.

Section 7621. Internal revenue districts

This section corresponds to that of the House bill except that your committee has restored the provisions of existing law which prohibit the combining of parts of 2 different States into 1 internal revenue district.

Section 7622. Authority to administer oaths and certify

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7623. Expenses of detection and punishment of frauds

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7641. Supervision of operations of certain manufacturers

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7651. Administration and collection of taxes in possessions

This section is identical with that of the House bill.

The section covers the following two matters:

(*a*) Paragraph (1) extends the collection authority and powers of the Internal Revenue Service to possessions of the United States so that if a delinquent taxpayer should remove himself or his property to a possession of the United States the Internal Revenue Service will have the same authority and power (such as the right to collect by levy and sale) to collect the tax from him, or to reach his property, in the possession as it would have within the United States. (It may be noted that two possessions of the United States are now included within internal revenue districts; namely, Puerto Rico and the Virgin Islands, as is the Canal Zone.)

(*b*) Paragraph (2) corresponds to section 3811 of the 1939 Code in the case of Puerto Rico and the Virgin Islands with respect to self-employment taxes and social security taxes. Paragraph (2) provides that if the tax is imposed within a possession (as distinguished from the case described in paragraph (1) of the section where the tax liability arises within the United States but the taxpayer or his property is within the possession), such tax shall be collected by the Secretary and paid into the Treasury of the United States as internal revenue collections, and all laws applicable to the administration, collection, and enforcement of such tax within the United States shall also be applicable in the possession. This paragraph differs from section 3811 in that it provides a uniform rule applicable to any possession and to any tax which may be imposed by the Internal Revenue Code in the particular possession.

Section 7652. Shipments to the United States

This section corresponds to that of the House bill except for a clerical change.

This section corresponds to sections 3350 and 3360 of the 1939 code. The only material change from existing law is the expression of the rules in such terms that they will be applicable if the taxes involved are collected by methods other than stamps, for example, by return.

Section 7653. Shipments from the United States

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7654. Payment to Guam and American Samoa of proceeds of tax on coconut and palm oil

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7655. Cross references

This section is identical with that of the House bill.

This section contains references to provisions relating to the imposition of tax in, and the applicability of other provisions to, possessions of the United States.

CHAPTER 79—DEFINITIONS

Section 7701. Definitions

This section corresponds to that of the House bill except for clerical changes and for the substantive changes noted below.

Section 7701 corresponds to section 3797 of the 1939 code. However, several new definitions have been added in this section.

Your committee has deleted the last sentence in paragraph (2) of the House bill. This conforms to the changes made in subchapter K of chapter 1.

Paragraph (12) of this section defines the term "Secretary or his delegate" to include any officer, employee, or agency duly authorized by the Secretary of the Treasury to perform any function mentioned or described in the context, whether authorized directly or indirectly by one or more redelegations of authority. The term "or his delegate" when used in connection with any other official of the United States is to be similarly construed.

Paragraph (15) of section 3797 of the 1939 code is an obsolete definition of "military or naval forces of the United States." More recent legislation has used the term "Armed Forces of the United States." Accordingly, paragraph (15) of section 7701 treats the terms as being identical. The definition in paragraph (15) corresponds to the definition now included in section 39.3797-11 of Internal Revenue Regulations 118 (the income tax regulations). Briefly stated, the term will include all of the uniformed forces of the Departments of Army, Navy, and Air Force, and will also include the Coast Guard

Your committee has added to paragraph (20), which defines the term "employee" to include certain full time life-insurance salesmen, a provision which will make the definition applicable in applying those sections of the income tax laws which relate to accident and health insurance or accident and health plans, or to employees' death benefits.

Paragraph (21) of this section is new. It defines the term "levy" to include the power of distraint and seizure by any means.

Paragraph (22) defines the term "Attorney General" to mean the Attorney General of the United States.

Paragraphs (23), (24), (25), and (26) of this section define the terms "taxable year," "fiscal year," "paid or incurred" and "paid or accrued," and "trade or business." These definitions correspond to the definitions in section 48 of the 1939 Code.

Paragraph (27) defines the term "Tax Court" to mean the Tax Court of the United States.

Paragraph (28) of this section relates to the use in this subtitle of terms defined in other subtitles. Many parts of subtitle F use, in a technical sense, terms defined in the basic subtitle levying the tax to which the administrative provisions relate. For example, the provisions prescribing the standards and requirements for the filing of returns will, in the case of the income tax, use a term defined in subtitle A, such as "gross income," and in the case of the estate tax return will use a term defined in subtitle B, namely, "gross estate." In order to make certain that the terms in this subtitle will be given the same meaning as in the subtitle imposing the tax, paragraph (28) provides that any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as in such provisions.

Paragraph (29) defines the term "Internal Revenue Code of 1954" to mean the code enacted by this bill, and defines the term "Internal Revenue Code of 1939" to mean the code, which has been in effect from 1939 until superseded by the code enacted by this bill.

Your committee has redesignated subsection (c) of the House bill as (d) and has added a new subsection (c) to this section to provide that any reference in this title to possessions of the United States shall be treated as also referring to the Commonwealth of Puerto Rico. This is a clarifying amendment and does not change existing law.

CHAPTER 80—GENERAL RULES

Section 7801. Authority of Department of the Treasury

This section, which is identical with that of the House bill, deals with the authority of the Department of the Treasury. Subsection (a), consistent with Reorganization Plans No. 26 of 1950 and No. 1 of 1952, provides that, except as otherwise expressly provided by law, the administration and enforcement of this title shall be performed by or under the supervision of the Secretary of the Treasury.

Subsection (b) provides that there shall be a General Counsel for the Department to be appointed by the President with the approval of the Senate. The General Counsel shall be the chief law officer of the Department and shall perform such duties as may be prescribed by the Secretary. The subsection further provides that the Secretary may appoint, and fix the duties of, an Assistant General Counsel to serve as Chief Counsel of the Internal Revenue Service, and not to exceed five other Assistant General Counsels. All the Assistant General Counsels shall be appointed without regard to the civil-service laws. The Secretary is also authorized to appoint and fix the duties of such other attorneys as he deems necessary.

Subsection (c) corresponds to section 3932 of the 1939 Code, relating to the functions of the Department of Justice.

Section 7802. Commissioner of Internal Revenue

This section, which is identical with that of the House bill, corresponds to section 3900 of the 1939 Code, and provides for the appointment of the Commissioner who shall have such duties as may be prescribed by the Secretary. This is existing law by virtue of Reorganization Plans No. 26 of 1950 and No. 1 of 1952. Provisions of section 3901 of the 1939 Code have been eliminated from this bill since under the reorganization plans all powers and duties of the Commissioner and other internal revenue officers and employees have been placed in the Secretary, subject to his power of delegation.

Section 7803. Other personnel

This section corresponds to that of the House bill except for a clerical change in subsection (c).

Subsections (a), (b), and (d) of this section contain no material changes from existing law.

Subsection (c) of this section changes existing law by authorizing the Secretary to purchase blanket or schedule bonds and to pay, from the appropriation for administrative expenses of the Internal Revenue Service, the premium of any such bonds or of any bonds required from officers or employees of the Internal Revenue Service.

Section 7804. Effect of reorganization plans

This section is identical with that of the House bill.

Subsection (a) of this section corresponds to section 616 of the Revenue Act of 1951. It is designed to preserve the reorganization plans (No. 26 of 1950 and No. 1 of 1952). This section provides that all functions vested by this title in any officer or employee or agency of the Department of the Treasury shall be subject to the plans. One important difference between this subsection and section 616 of the Revenue Act of 1951 is that this subsection provides that the reorganization plans will also apply to any act amending this title, unless such amending act expressly provides to the contrary.

Subsection (b) of this section, which corresponds to the provisions of section 3 of Public Law 567, 82d Congress, contains no material change from existing law.

Section 7805. Rules and regulations

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7806. Construction of title

This section is identical with that of the House bill.

Subsection (a) of this section corresponds to section 2 of the 1939 code.

Subsection (b) of this section corresponds to provisions which were included in the enacting clause of the Internal Revenue Code of 1939. These provisions are to the effect that no inference shall be drawn from the arrangement and classification of the provisions in the code, or from the side notes and ancillary tables contained in the various prints of this act before its enactment into law.

Section 7807. Rules in effect upon enactment of this title

This section corresponds to that of the House bill except for a clarifying change.

Subsection (a) of this section is an interim provision for administration of the title until regulations are promulgated under any provision of this title which depends for its application upon the promulgation of regulations (or which is to be applied in such manner as may be prescribed by regulations). Under subsection (a) the present rules or regulations of the Internal Revenue Service are to be given effect until the necessary regulations are promulgated. For example, this subtitle requires property seized by levy to be sold in accordance with regulations. Until such regulations are issued, the sale shall be made under existing rules (whether or not published) of the Internal Revenue Service which would be valid if issued under this title, Thus, if the time and method for making the sale are covered by instructions issued to district directors which would be valid under this title if issued as regulations thereunder, such rules shall continue to apply until appropriate regulations are issued.

Subsection (b) of this section has been rewritten by your committee for the purpose of clarity and, as in the House bill is designed to preserve the effect under this title of any election or other act (authorized under this title) which was in fact made under the corresponding provisions of prior law. It also provides the applicable rule for those cases where the provisions of this title refer to the application of this title to prior periods which were subject to the 1939 code rather than to this new code. Briefly stated, subsection (b) is designed to handle the problem of transition from the 1939 code to the 1954 code by providing, in effect, that the 1954 code shall be applied (insofar as it depends upon the application of the law to a prior period) as if the new code were a continuation of the 1939 code with the changes in law incorporated in the new code having been made by amendment (with the same effective date as the date such change is effective under the 1954 Code) to the appropriate sections of the 1939 Code.

Section 7808. Depositaries for collection

This section, which is identical with that of the House bill, contains no material change from existing law.

Section 7809. Deposit of collections

This section is identical with that of the House bill and contains no material change from existing law.

Section 7851. Applicability of revenue laws

This section corresponds to that of the House bill except for several substantive and technical changes noted below.

Subsection (a) of this section provides effective dates for the application of the 1954 Code and for the repeal of the provisions of the 1939 Code. Briefly stated, this subsection of the House bill provided that the 1954 Code will apply (and the corresponding provisions of the 1939 Code are repealed):

(1) In the case of the income tax, with respect to taxable years beginning after 1953 (except any short taxable year which does not end after the date of enactment of the 1954 Code);

(2) In the case of the estate tax, with respect to estates of decedents dying after the date of enactment of this bill; and

(3) In the case of gift taxes, employment taxes, excise taxes, alcohol and tobacco taxes, and machine guns and certain other firearms taxes, on January 1, 1955.

Briefly stated, your committee has amended subsection (a) to make this code applicable on the day after the date of its enactment in the case of the taxes on machine guns and certain other firearms.

Paragraph (1) of subsection (a) provides that chapters 1, 2, 4, and 6 of the 1954 Code shall apply only with respect to taxable years beginning after 1953 and ending after the date of enactment of the 1954 Code. These chapters relate to normal taxes and surtaxes on income, the tax on self-employment income, the recovery of excessive profits on Government contracts, and consolidated returns. With respect to taxable years beginning before 1954, and short taxable years beginning after 1953 and not ending after the date of enactment of the 1954 Code, chapter 1 (except secs. 143 and 144, relating to withholding), chapter 2, and section 3801, of the 1939 Code are continued in force. It may be noted that the provisions of chapter 1, which will apply to taxable years to which the 1954 Code is not applicable, include many administrative provisions which will remain in effect with respect to such taxable years, such as the provisions for filing returns, the provisions with respect to periods of limitation, the provisions with respect to the determination of deficiencies, the provisions for additions to the tax in case of delinquency in filing the return, or negligence or fraud, the provisions for interest on deficiencies, etc.

The provisions of subtitle A of the 1954 Code relating to withholding of tax, namely, chapter 3, are made applicable, in the House bill, to payments made after the date of enactment of the 1954 Code. Your committee has amended paragraph (1) (B) of subsection (a) to make the provisions of chapter 3 applicable to payments made after December 31, 1954; the corresponding provisions of sections 143 and 144 of the 1939 Code will remain in effect with respect to payments made before January 1, 1955.

The provisions of chapter 5 of the 1954 Code, relating to transfers to avoid income tax, are made applicable under the House bill, to transfers made after the date of enactment of the 1954 Code. Your committee's amendment to paragraph (1) (B) of subsection (a) makes the provisions of chapter 5 applicable to transfers made after December 31, 1954; the corresponding provision of the 1939 Code (ch. 7 thereof) will remain in effect with respect to transfers made prior to the date on which such chapter 5 becomes applicable.

Subparagraph (C) provides that any provision of subtitle A (income taxes) which contains a provision stating its applicability in terms of a specific date (occurring after December 31, 1953) or in terms of the taxable year ending after a specific date (occurring after December 31, 1953), shall apply to taxable years ending after such date. These provisions are, in the case of taxable years subject to the 1939 Code, to be considered a part of that code, but are to be applicable only to taxable years ending after the specific date. For example, section 116 of the 1954 Code (partial exclusions of dividends received by individuals) will apply to a fiscal year individual whose fiscal year ends September 30, 1954, even though such taxable year began before January 1, 1954, and is therefore subject to the 1939 Code. In the case of many such provisions in this code, no specific provision is made with respect to the rules which are applicable prior to the specific date. Your committee has amended this subsection to provide that in any such case those rules shall apply which are provided by the 1939 Code and which would be superseded if the provisions applicable after the specific date were an amendment of the 1939 Code except that section 2039 (c) of this bill applies to decedents dying after December 31, 1953.

Paragraph (2) of subsection (a) contains the general rule for applicability of subtitle B (estate and gift tax). Subparagraph (A) provides that chapter 11 (estate tax) shall apply only to estates of decedents dying after the date of the enactment of the 1954 Code, and with respect to such estates chapter 3 of the 1939 Code is repealed. The tax on estates of decedents dying on or before the date of enactment of the 1954 Code will be determined under chapter 3 of the 1939 Code.

Subparagraph (B) provides that chapter 12 (gift tax) shall apply with respect to calendar years 1955 and after, and with respect to those years chapter 4 (gift tax) of the 1939 Code is repealed. The tax on gifts made on or before December 31, 1954, will be governed by the 1939 Code.

As in the case of the income tax, the estates subject to the estate tax imposed by the 1939 Code, and the calendar years subject to the gift tax imposed by that code, will also continue to be subject to the administrative provisions contained in chapters 3 and 4 of such code, which chapters are continued in effect with respect to such estates and such calendar years. Thus, the requirements for the filing of returns, the provisions relating to deficiencies, additions to the tax, interest, periods of limitation, etc., provided in such chapters 3 and 4 remain in effect with respect to the taxes to which such chapters are applicable.

Paragraph (3) contains the general rule for applicability of subtitle C (employment taxes). This subtitle applies only with respect to remuneration paid after December 31, 1954, except for chapter 22 (Railroad Retirement Tax Act) which shall apply with respect to remuneration paid after December 31, 1954, for services rendered after that date. Chapter 9 (employment taxes) of the 1939 Code is repealed with respect to remuneration paid after December 31, 1954, except that subchapter B (which corresponds to ch. 22 of the 1954 Code), and subchapter E (administrative provisions) to the extent that it relates to subchapter B, will remain applicable with respect to remuneration paid after December 31, 1954, for services performed on or before that date. In the case of payments of remuneration to which chapter 9 applies, the provisions of the 1939 Code with respect to the requirements for collecting and paying over the tax, filing returns, interest, additions to the tax, and periods of limitation remain applicable. Many of these provisions are included in chapter 9, which chapter remains in effect with respect to such remuneration, and other such provisions are included in chapter 28 and subtitle D of the Internal Revenue Code of 1939.

Paragraphs (4) and (5) of subsection (a), in the House bill, provide that subtitle D (relating to miscellaneous excise taxes) and subtitle E (relating to alcohol, tobacco, and certain other excise taxes) shall apply on and after January 1, 1955.

Your committee has amended paragraph (5) of subsection (a) to provide that subtitle E shall take effect on January 1, 1955, except that the provisions of chapter 53 (relating to taxes on machineguns and certain other firearms), the provisions in section 5411 permitting the use of a brewery under regulations prescribed by the Secretary or his delegate for the purpose of producing and bottling soft drinks, and the provisions of section 5554 (relating to pilot-plant operations), shall take effect on the day after the date of enactment of this title. Your committee has made conforming changes with respect to the repeal of the provisions of the 1939 Code.

Except for the change noted above, these paragraphs also provide that subtitles B and C (except chs. 7, 9, and 28 thereof) of the 1939 Code are repealed effective January 1, 1955. These subtitles of the 1939 Code relate to excise taxes, including alcohol and tobacco taxes. Thus, except for the taxes on machineguns and certain other firearms provided for in subchapter B of chapter 25, and part VIII of subchapter A of chapter 27 of the 1939 Code, all other excise taxes (including alcohol and tobacco taxes) will be imposed under the 1939 Code until January 1, 1955, and on and after that date they will be imposed under the 1954 Code. As in the case of other taxes, the administrative provisions of the 1939 Code (other than those specifically made inapplicable after the date of enactment of the 1954 Code or after December 31, 1954, by par. (6) of subsec. (a), which is discussed below) will continue to apply to the taxes and other liabilities imposed under the 1939 Code. The requirements with respect to stamps, and the requirements for the filing of returns, the provisions relating to deficiencies, additions to the tax, interest, periods of limitation, etc., provided in the 1939 Code will remain in effect with respect to these excise taxes (including alcohol and tobacco taxes) imposed under the 1939 Code. Although the special occupational tax is paid for engaging in business during the special tax year beginning July 1 and ending June 30, the fact that the 1954 Code becomes applicable on a date other than July 1 will not interrupt the running of the special tax year so as to require an additional payment of tax solely by reason of the reenactment in the new code of the same special tax provisions which are now included in the 1939 Code. See section 7807 (b) (2).

Paragraph (6) of subsection (a) of the House bill provided that subtitle F of the 1954 Code, relating to procedures and administration, will apply on and after the day after the enactment of such code to the taxes imposed by the 1954 Code. When it becomes applicable as to those taxes, it will be fully applicable regardless of whether its provisions relate to an event prior or subsequent to the date on which it becomes applicable. Thus, for example, the requirement in section 6011 that an income-tax return be filed for the taxable year if the gross income is $600 or more is applicable to a taxpayer on the calendar-year basis for the calendar year 1954, even though he may have received the gross income prior to the date of enactment of the 1954 Code. Although, as indicated above, many of the administrative provisions of the 1939 Code will remain applicable to the taxes imposed under that code, such as provisions relating to the requirement for filing returns, additions to the tax, interest, periods of limitation, etc., paragraph (6) of subsection (a) of the House bill specifically makes applicable to such taxes certain of the general administrative provisions of the 1954 Code. These provisions will apply notwithstanding any contrary provisions of the 1939 Code, and therefore supersede such contrary provisions. The provisions of the 1954 Code which apply to the taxes imposed by the 1939 Code are the type which are not closely related to a particular tax but involve the general administration of the revenue. For example, under the House bill after the date of enactment an assessment of taxes imposed by the 1939 Code will be made in the same manner as an assessment of taxes imposed by the 1954 Code. Similarly, after such date, the provisions of the 1954 Code relating to levy and sale will apply to the collection of taxes imposed by both codes.

Your committee, however, has amended paragraph (6) so that the provisions of the 1954 Code relating to assessment (other than the provisions relating to deficiency procedures in the case of income, estate, and gift taxes), collection, and abatements, credits, and refunds shall become applicable to taxes under both the 1939 Code and the

1954 Code on January 1, 1955, and so that prior to such date the corresponding provisions of the 1939 Code shall remain in effect with respect to taxes under both the 1939 Code and the 1954 Code.

Chapter 75 of the 1954 Code relates to crimes and other offenses which are punished by proceedings in court. Under paragraph (6) of subsection (a), this chapter will become applicable, on the day after the date of enactment of the 1954 Code, to offenses therein described committed after the date of enactment, with respect to taxes under the 1939 Code. If the criminal or civil penalties (collectible by suit) provided in chapter 75 relate to an offense (committed after the date of enactment of the 1954 Code) with respect to a tax imposed by the 1939 Code, any criminal penalties or civil penalties (collectible by suit) under the 1939 Code will not apply, but the penalties under chapter 75 will be the only penalties of such nature applicable to the offense. Among other provisions of the 1954 Code which will become applicable to taxes imposed by the 1939 Code are the definitions in chapter 79. These definitions will supersede the definitions in section 3797 of the 1939 Code. They, of course, do not supersede any specific definition included in provisions of a chapter of the 1939 Code imposing a tax under that code.

Paragraph (7) of subsection (a), except for a clerical change, is the same as the House bill and provides that any provision not otherwise provided for will take effect on the day after enactment of the 1954 Code. It also provides for the repeal of those provisions of the 1939 Code not otherwise provided for, effective on the day after enactment of the 1954 Code.

Subsection (b) of the House bill contained provisions relating to the effect of the repeal of the 1939 Code on existing rights and liabilities, and the effect of such repeal on existing offices, appointments, etc. Your committee has amended subsection (b) by including the provisions relating to existing rights and liabilities in paragraph (1) of subsection (b), by including the provisions relating to existing offices, appointments, etc., in paragraph (2) and by making certain changes in this provision as described below, and by adding a new paragraph (3), described below, with respect to existing delegations of authority.

Subsection (b) provides that the repeal of any provision of the 1939 Code will not affect acts done or rights accrued or accruing or any suit or proceeding had or commenced before the repeal, but all rights and liabilities under the 1939 Code will continue and may be enforced as if the repeal had not been made. For example, the liability for any tax imposed by the 1939 Code prior to its repeal will continue until paid notwithstanding such repeal.

Subsection (b) of the House bill provided that all offices, positions, appointments, employments, boards, or committees authorized by the 1954 Code shall not be abolished by repeal of the provisions of the 1939 Code, but shall continue under the pertinent provisions of the 1954 Code. Your committee has made clarifying changes in this provision and has further amended this provision to include internal revenue districts. The provision adopted by your committee is designed to continue (despite the repeal of the 1939 Code and the enactment of the 1954 Code) all offices, positions, boards, and committees, all appointments and employments of officers and employees, and all internal revenue districts, existing immediately prior to the enactment of the 1954 Code, the continuance of which is not manifestly inconsistent with any provision of the 1954 Code. It is also made clear that, in every such case, the authority to make changes shall not be restricted by this provision of the 1954 Code.

Your committee has added a new paragraph relating to existing delegations of authority. This paragraph provides that, notwithstanding the repeal of the 1939 Code, any delegation of authority made pursuant to the provisions of Reorganization Plan No. 26 of 1950 or Reorganization Plan No. 1 of 1952, including any redelegation of authority made pursuant to any such delegation of authority, and in effect under the 1939 Code immediately preceding the enactment of this code, shall remain in effect for purposes of the 1954 Code, unless distinctly inconsistent or manifestly incompatible with the provisions of the 1954 Code. This provision does not limit in any manner the power to amend, modify, or revoke any such delegation or redelegation of authority.

Subsections (c), (d), and (e) of the House bill have been continued without change in the bill reported by your committee.

Subsection (c) provides that offenses committed and penalties or forfeitures incurred under the provisions of the 1939 Code which are repealed may be prosecuted and punished with the same effect as if the 1954 Code had not been enacted.

Subsection (d) provides that all periods of limitation, both civil and criminal, which are repealed shall continue to apply to all suits, proceedings, or prosecutions, whether civil or criminal, for causes arising or acts done or committed before such repeal, as if the 1954 Code had not been enacted.

Subsection (e) provides that, for the purpose of applying the 1939 Code or the 1954 Code to any period, a reference in either the 1939 Code or the 1954 Code to a provision of either such code which is not then applicable shall be deemed a reference to the corresponding provision of the other code.

Section 7852. Other applicable rules

This section corresponds to that of the House bill except for a change in subsection (b) and a change in subsection (d), both of which are discussed below.

Subsection (a) provides for the separability of any provision of this title which is held invalid as to any person or circumstance.

Subsection (b) of the House bill provided that references in other laws of the United States to any provision of the Internal Revenue Code of 1939 shall, when appropriate, be deemed references to the corresponding provision of this title unless otherwise expressed. Your committee has amended this subsection to make it also applicable to any Executive order which refers to a provision of the 1939 Code.

Subsection (c) prevents a double deduction of, or a double inclusion in income of, the same item for income-tax purposes under chapter 1 or 2 of the 1939 Code and subtitle A of this title unless specifically provided for. For example, if in 1954 a taxpayer on the calendar-year basis takes a deduction for an embezzlement loss discovered in that year, the same loss may not be deducted for any prior year under the 1939 Code, without regard to when the embezzlement occurred.

Subsection (d) of the House bill provided that no section of this title shall apply in abrogation of any treaty obligation of the United

States. Your committee has amended this subsection to make it clear that it applies only to treaties in effect on the date of enactment of this title.

SUBTITLE G—THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

This subtitle, which is identical with that of the House bill, contains no change from existing law.

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