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PREPAID INCOME AND RESERVE FOR ESTIMATED EXPENSES

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-FOURTH CONGRESS

FIRST SESSION

ON

H. R. 4725

AN ACT TO REPEAL SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

MAY 11 AND 12, 1955

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PREPAID INCOME AND RESERVE FOR ESTIMATED EXPENSES

WEDNESDAY, MAY 11, 1955

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

The committee met, pursuant to call, at 10:10 a. m., in room 312 Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, George, Kerr, Frear, Johnson (Texas), Millikin, Martin (Pennsylvania), Williams, Flanders, Carlson, and Bennett.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

We have for consideration H. R. 4725.

(H. R. 4725 is as follows:)

[H. R. 4725, 84th Cong., 1st sess.]

AN ACT To repeal sections 452 and 462 of the Internal Revenue Code of 1954

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REPEAL OF SECTIONS 452 AND 462.

(a) PREPAID INCOME.—Section 452 of the Internal Revenue Code of 1954 is hereby repealed.

(b) RESERVES FOR ESTIMATED EXPENSES, ETC.—Section 462 of the Internal Revenue Code of 1954 is hereby repealed.

SEC. 2. TECHNICAL AMENDMENTS.

The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Subsection (c) of section 381 is amended by striking out paragraph (7) (relating to carryover of prepaid income in certain corporate acquisitions).

(2) The table of sections for subpart B of part II of subchapter E of chapter 1 (relating to taxable year for which items of gross income included) is amended by striking out

"Sec. 452. Prepaid income."

(3) The table of sections for subpart C of such part II (relating to taxable year for which deductions are taken) is amended by striking out—

"Sec. 462. Reserves for estimated expenses, etc."

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 4. SAVING PROVISIONS.

(a) FILING OF STATEMENT.—If—

(1) the amount of any tax required to be paid for any taxable year is increased by reason of the enactment of this Act, and

(2) the last date prescribed for payment of such tax (or any installment thereof) is before September 15, 1955,

then the taxpayer shall, on or before September 15, 1955, file a statement which shows the increase in the amount of such tax required to be paid by reason of the enactment of this Act.

(b) FORM AND EFFECT OF STATEMENT.—

(1) FORM OF STATEMENT, ETC.—The statement required by subsection (a) shall be filed at the place fixed for filing the return. Such statement shall be in such form, and shall include such information necessary or appropriate to show the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this Act, as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(2) TREATMENT AS AMOUNT SHOWN ON RETURN.—The amount shown on a statement filed under subsection (a) as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this Act shall, for all purposes of the internal revenue laws, be treated as tax shown on the return.

(3) WAIVER OF INTEREST IN CASE OF PAYMENT ON OR BEFORE SEPTEMBER 15, 1955.—If the taxpayer, on or before September 15, 1955, files the statement referred to in subsection (a) and pays in full that portion of the amount shown thereon for which the last date prescribed for payment is before September 15, 1955, then for purposes of computing interest (other than interest on overpayments) such portion shall be treated as having been paid on the last date prescribed for payment. This paragraph shall not apply if the amount shown on the statement as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this Act is greater than the actual increase unless the taxpayer establishes, to the satisfaction of the Secretary of the Treasury or his delegate, that his computation of the greater amount was based upon a reasonable interpretation and application of sections 452 and 462 of the Internal Revenue Code of 1954, as those sections existed before the enactment of this Act.

(c) SPECIAL RULES.—

(1) INTEREST FOR PERIOD BEFORE ENACTMENT.—Interest shall not be imposed on the amount of any increase in tax resulting from the enactment of this Act for any period before the day after the date of the enactment of this Act.

(2) ESTIMATED TAX.—Any addition to the tax under section 294 (d) of the Internal Revenue Code of 1939 shall be computed as if this Act had not been enacted. In the case of any installment for which the last date prescribed for payment is before September 15, 1955, any addition to the tax under section 6654 of the Internal Revenue Code of 1954 shall be computed as if this Act had not been enacted.

(3) TREATMENT OF CERTAIN PAYMENTS WHICH TAXPAYER IS REQUIRED TO MAKE.—If—

(A) the taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of this Act, and

(B) the Internal Revenue Code of 1954 prescribes a period, which expires after the close of the taxable year, within which the taxpayer must make such payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then, subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, if such payment (or additional payment) is made on or before September 15, 1955, it shall be treated as having been made within the period prescribed by such Code.

(4) DETERMINATION OF DATE PRESCRIBED.—For purposes of this section, the determination of the last date prescribed for payment or for filing a return shall be made without regard to any extension of time therefor and without regard to any provision of this section

(5) REGULATIONS.—For requirement that the Secretary of the Treasury or his delegate shall prescribe all rules and regulations as may be necessary by reason of the enactment of this Act, see section 7805 (a) of the Internal Revenue Code of 1954.

Passed the House of Representatives March 24, 1955.

Attest:

RALPH R. ROBERTS,
Clerk.

The CHAIRMAN. The first witness is Hon. George M. Humphrey, the Secretary of the Treasury.

STATEMENT OF HON. GEORGE M. HUMPHREY, SECRETARY OF THE TREASURY, ACCOMPANIED BY LAURENS WILLIAMS, ASSISTANT TO THE SECRETARY, AND DAN T. SMITH, ASSISTANT TO THE SECRETARY DEPARTMENT OF THE TREASURY

The CHAIRMAN. Mr. Humphrey, we are delighted to have you with us.

Secretary HUMPHREY. Mr. Chairman, I am delighted to have an opportunity to be here before you to present the views of the Treasury Department on the matter. I have a short statement and, with your permission, I will read it.

The CHAIRMAN. Proceed, Mr. Secretary.

Secretary HUMPHREY. Mr. Chairman and members of the committee, I am here today to urge the repeal of sections 452 and 462 of the Internal Revenue Code of 1954.

The original objective of these two sections, which cover prepaid income and reserves for estimated expenses, was simply to conform tax accounting with business accounting. It was never intended that these provisions would result in any substantial loss of revenue or result in windfalls to taxpayers. A review of the consideration of this subject by this committee will confirm the impression held at the time by lawyers, accountants, and businessmen that the basic motive for these provisions was simplification of tax accounting procedures, and not radical tax reductions.

This tax law became effective on August 16, 1954, During the fall, as the knowledge of its provisions increased, there began to be rumors that these particular provisions might not work as originally intended.

Before the end of the year, studies by the Treasury staff, working with the staff of your committee, were undertaken to see if the threatened situation could properly and effectively be cured by regulation. Proposed regulations were issued on January 22. However, until the time came when these provisions began to be put into actual practice by taxpayers preparing their income tax returns and the 30 days expired for protests against the proposed regulations, there was not much reliable information available.

It then developed that there is a sharp difference of opinion between taxpayers and the Government as to the scope of these sections. The tentative regulations issued by the Treasury on January 22, in order to carry out the provisions of the law, have come under strong attack as being too restrictive in limiting the intended application of the sections. Taxpayers have already served notice that they intend to litigate this restriction. Should they be successful in the courts, the revenue loss under the law might be far in excess of anything contemplated by the Congress. As soon as the checks were sufficiently conclusive to satisfy the staff that the original objective might not be carried out and that the situation could not be adequately corrected by regulation, they reported their findings and we promptly called the matter to the attention of the Congress.

The original estimate for several so-called bookkeeping items, of which Sections 452 and 462 were the principal revenue items, was $47 million. The limited check that we have made around the country indicates that the loss would be substantially greater than the original estimates. How much greater it might be we cannot now say because

we simply do not have the information as to what the bulk of taxpayers concerned might claim should these provisions remain in the law. And with the litigation that would surely be involved in many cases should the provisions remain, we might not have final figures on the loss for years to come.

Repeal of these two provisions will reinstate the legal rights of everyone just as they were under the old law prior to last August and protect the Government from revenue loss which was never intended by the Congress.

The objective of trying to conform tax accounting with business accounting is still a sound one. In trying to do this, however, a serious mistake was made in not sufficiently limiting the application of the provisions and restricting the revenue impact of the changes as enacted. That is why repeal is required rather than amendment, so as to be sure that in any new approach to the original objective the revenue is adequately protected.

We have studied many proposals to correct the situation by amendment of the sections rather than repeal, but we have found no proposal which we can be sure will accomplish the original objective without giving some taxpayers an unintended advantage or producing very involved technical problems creating uncertainty and litigation.

The Treasury Department is firmly opposed to any tax legislation which gives any American an unfair advantage over another taxpayer. We will always recommend prompt action be taken to correct any situation which can result in windfalls to any taxpayer. To firmly follow out our policy of being as fair and just to all taxpayers as is humanly possible, I am urging outright repeal of the two sections which would have resulted in some taxpayers getting a break over others.

As the chairman knows, I sent the chairman of the House Ways and Means Committee last week a letter stating that none of the other approximately 70 suggestions for perfecting the Internal Revenue Code of 1954 require immediate legislation. With this the chairman of the House Ways and Means Committee agreed in a letter which was made public last Friday along with my letter to him. All of the suggestions considered by the staffs of the Joint Committee on Internal Revenue Taxation, the Ways and Means Committee, and the Treasury, are wholly noncontroversial. More than half are clerical errors, such as misprints, misspelling, bad punctuation, and like errata with no legal significance. Other suggestions pertain to items on which the Treasury could issue better regulations if somewhat more precise statutory language were adopted. The revenue effect of the suggestions is insignificant, if indeed they have any overall revenue effect.

That completes my statement, Mr. Chairman, except for one thing. I want to say that we are continuously studying the effect of this law as it moves into practice, as the various changes are worked out by the taxpayers in filing their returns. We are keeping very close track of them. And if and when at any time it appears that the intent of Congress is not being carried out as originally intended, we will be back with suggested amendments.

The CHAIRMAN. Thank you very much, Mr. Secretary.

Any questions, Senator George?

Senator GEORGE. I have none.

The CHAIRMAN. Senator Millikin?

Senator MILLIKIN. Mr. Secretary, was there sufficient notice last year for the taxpayers complying with those provisions so that they might modify them in time and not get caught with them?

Secretary HUMPHREY. No; I don't think they were caught. I think a great many people filed their tax returns, taking advantage of these sections in all sorts of ways. What might be estimated as deductions started in a relatively small way and kept rolling like a snowball. One fellow would think of one thing, and another, another, and it kept rolling up, and I think a great many taxpayers took advantage of this as time went on in the filing of their returns.

Now, before their final returns were filed, in many cases they had notification of our objection to them, in some case they didn't. But even so, they are denied nothing by the repeal of this except something which is not intended. Nobody is prejudiced by the repeal of this, except in a case of this kind, Senator.

It is perfectly possible that there might be a case somewhere where a man was contemplating paying a tax and his accountants came to him and said, "No, here is a provision under which we can get deductions that will eliminate your paying that tax." So they put in the provisions, and then he thought he was not going to have to pay the tax.

Now, up to that point he is not hurt, because a reversal of that would just leave him where he was before. But if he went ahead and spent the money that he was going to save to pay the tax with, and then had it reversed and has to pay the money to the Government for the tax, there might be some hardship in a case of that kind.

But those cases, of course, would be extremely few and far between, because almost everybody had notice that this matter was being brought up for reconsideration before they could spend the money on the tax return that was prepared.

Senator MILLIKIN. Thank you very much, Mr. Secretary.

The CHAIRMAN. What was the date, Mr. Secretary, that the announcement was made of a likelihood that this would be repealed?

Secretary HUMPHREY. I will have to check that, Mr. Chairman. I think I went to the Ways and Means Committee and asked for a repeal of this early in March. This came up, however, for public questioning back in January. And those regulations went out on January 22.

And, when the regulations went out on January 22, that gave notice to everybody that this was expressly limited, because when those regulations went out it was then that we got the storm of protest that our regulations were too restrictive and that they did not permit the leeway that the taxpayers expected.

So that I would say that any time after January 22, anyone who was contemplating movement here had notice that there was great restriction over what many people were then suggesting.

The CHAIRMAN. Then those who made these deductions are protected from any penalties of any kind?

Secretary HUMPHREY. That is right; there will be no penalties, they will be put in a status exactly as they were before, and the regulations with respect to other deductions, particularly vacation pay, will be carried clear through this year.

The CHAIRMAN. What is the date, then, that those who have paid the tax and made deductions will have to make the additional payment?

Secretary HUMPHREY. September 15. And there is no interest.

The CHAIRMAN. Senator Frear.

Senator FREAR. I have nothing, except, Mr. Secretary, I think it was also the intention of the Treasury that there be no revenue loss, not only of the Congress but of the Treasury.

Secretary HUMPHREY. That is right. It was our intention, everybody's intention. This was just a bad mistake that we made in the Treasury, to start with, that was carried through, and nobody caught it.

The CHAIRMAN. In other words, you estimated it at $47 million, and it was very much above that?

Secretary HUMPHREY. That is right. We do not know what it is, but it will be very much more than that; 10 or 20 times that.

The CHAIRMAN. Senator Martin.

Senator MARTIN. That was the question I was going to ask, Mr. Chairman. I have had a good many people say to me that they did not think the loss would be anywhere near as large as we have been discussing. And I think that that is a pretty important thing.

Secretary HUMPHREY. I think this, Senator: We are trying to estimate what the loss will be. It is extremely difficult to do that, because, in the first place, how far you can go with regulations that would restrict this activity within the law is a very indefinite matter, that is one of the difficulties with it, we do not know just where the regulations can saw it off. So, until we know that, you do not know.

Then you do not know what claims may be made. But our best estimate is that this could run, somewhere, within regulations that could probably be issued, $400 million, up to twice that, perhaps.

Senator MARTIN. What objection would there be to extending more time beyond September 15 of this year in the adjustment?

Secretary HUMPHREY. I don't believe there is any hardship to anyone going to September 15. You could do that if you wanted to, but I don't see any reason. Nobody should be hurt by this in any way. All this was a hope that we would get something, and the hope is retracted. That is all.

They all had notice in plenty of time, and I don't see how anybody would be hurt by it.

Senator MARTIN. The American people, of course, are pretty ambitious, and when they felt that there was probably some additional money that might be permanently invested—I am wondering in cases like that whether they might have more time than September 15. We are in a period now where we are borrowing too much money, and everybody is trying to put in as much equity capital as they can.

And if a person, an individual, felt that, well, here is some money now I will have to invest—Mr. Secretary, I am very much worried about the debt, not only public but private, in the United States, this thing of signs in shop windows, "No downpayment"—I have been kind of worried that probably some very good people might be caught in this.

Now, you folks have a better opportunity of knowing of this. I am just asking for information.

Secretary HUMPHREY. We haven't heard of a case.

I will say this, Senator: You have some associates in the room who are just as worried as you are about our debts, and I in no way discount that. I am just as worried, and I know a number of the rest of you here are, just as worried about how we handle and what we do with the amount of debt that there is and how it works and how it affects the economy, maybe.

This is something that I don't think any of us know. But it is something that we must never let get our of our minds.

Senator MARTIN. I don't have anything further now, Mr. Chairman.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. No questions

The CHAIRMAN. Senator Flanders.

Senator FLANDERS. Mr. Secretary, I am constitutionally concerned—I don't mean United States constitutionally, but personally constitutionally—disturbed by any retroactive applications of this sort.

Your statement diminishes the kind and degree of retroactivity, but there is a little of it still left, and I have to swallow pretty hard on anything that is retroactive. Now, can you say clearly and definitely that there is no retroactive adjustment required on anything that was intended in the original legislation?

Secretary HUMPHREY. I think so. I think that what we intended, what was intended here, was simply a bookkeeping readjustment. Now, what has worked out is a double deduction. And the thing that people are interested in, regardless of what everybody says, the thing that people are interested in here is getting a double deduction in 1 year.

The reason we object to that and want it repealed is because I don't think that any special groups of people ought to get a double deduction when other people don't. And any scheme that you work out, almost any scheme that you work out, results in a double deduction.

Senator FLANDERS. Now, the next question related to this is in connection with your January 22 administrative release, as to the administration of this act. Is there anything in this H. R. 4725 that goes beyond what you are trying to do administratively in your January 22 release?

Secretary HUMPHREY. Well, yes, I think so.

In other words, that was our trouble. When we came to make up our January 22 regulations, we found that we could not restrict this to prevent some double deduction out of this unless we got so complicated—unless you got out such a complicated situation with respect to it to try to avoid the double deduction, that you are applying one estimate on another estimate and getting into a maze of difficulties.

Senator FLANDERS. So your January 22 document didn't go all the way you wanted to, and you found it impossible to go all the way you wanted to?

Secretary HUMPHREY. That is right.

Senator FLANDERS. And how far you wanted to go was to carry out the original intent of the act?

Secretary HUMPHREY. That is right, which was simply a bookkeeping matter.

Senator FLANDERS. Well, that sounds all right.

Now, the next thing is—is there anything in this that relates to the provisions for taking care of prepaid insurance?

Secretary HUMPHREY. Well, what we want to do is to put all of these things back just where they were before this was passed, to leave them exactly where they were previously. And those prepayments which were properly accounted for before will still be properly accounted for.

The estimates, the proper estimates of deductions, will be in exactly the same way. We just want to leave people where they were, we don't want to make any change.

Senator MILLIKIN. Mr. Chairman, I hope before the Secretary finishes that we can have some example of what was intended and how it was worked out, by examples, so that we would know exactly what he is talking about.

Secretary HUMPHREY. I shall be glad to develop that.

The CHAIRMAN. When you do that, would you discuss separately sections 452 and 462, and give an explanation of each?

Secretary HUMPHREY. They are complementary. The first one relates to the receipt of income that is applicable not only to the current year but the future years. The complementary feature is the second one, which relates to the accrual of expenditures, which relate not only to the current year—which are not paid out in the current year but which relate to it and will be paid in a subsequent year. I think that is the way it works.

Now, as to the second, the common illustration is of some accrual item. I think the biggest item that ran into the most money and that caused the most concern was a matter of maintenance and repairs. And under this second item, under the accrual item of maintenance and repairs, people thought they were permitted by this language to estimate what their maintenance and repairs might be in the future that would be applicable to the present, current year.

Now, when you are able to do that, they not only would take the actual amount of money spent—let's take this year—they not only would deduct the full amount of money that they spent on maintenance and repairs this year, but on top of that they would estimate what they were going to spend in the future that would be applicable to this year, so they would get it twice, you see.

The CHAIRMAN. Will you explain more clearly what you mean by "applicable to this year"?

Secretary HUMPHREY. Well, that took place this year but wasn't paid this year. And you would estimate that. And what it did, just very frankly, was to put a premium on overestimating what your maintenance and repairs this year that would be paid in the future might be, because there was no penalty on overestimating, and you knew you had a substantial tax to pay this year, so there would be an estimate made; you would pay out what you actually spent and deduct that, and deduct what you might spend in the future and put that back in, and so you had a double deduction this year, with no limitation on what the estimate was except controversies between the Department and the taxpayer.

The CHAIRMAN. Under section 462, for example, if you manufactured certain products in 1954 and you had those on hand, you could then deduct an estimated cost for the sale and handling of those products that were manufactured in 1954; is that correct?

Secretary HUMPHREY. Deduct estimated expenditures in the future, yes.

The CHAIRMAN. For the purpose of selling and handling or storing its products manufactured in 1954, the cost of selling them could be estimated and deduct——

Secretary HUMPHREY. No; it would be more like this:

Where I sold a television set this year, I would charge all of my cost of selling that television set this year. But, say I sold that television set in December, with a guaranty that I would keep it in repair for 6 months. Now, then, I sold it in December, and I charged all of my expenses that had already accrued against that sale in December. Then I would estimate how much I would have to spend during the following 6 months to keep it in repair. And that might be so many dollars.

And then I would bring that back and add that on, and make it a deduction this year instead of next year.

The CHAIRMAN. Suppose that television set was on hand in December, the 31st of December or the 1st of January, and there were certain costs involved to selling it in the coming year, which would be 1955. You could estimate that?

Secretary HUMPHREY. No. That would be paid when you sold the set. You see, all you are talking about here, gentlemen, is which year you take it. Theoretically, you can't get more than you actually spend. It is just a question of which year it is in.

But the difficulty is when you are estimating what you are going to spend, maybe you estimated too high, and go along for years with an estimate that is too high on which you have paid no tax.

The CHAIRMAN. In what category would this great loss come?

Secretary HUMPHREY. The loss comes, very largely—one of the biggest items is the one I mentioned, maintenance and repairs; you can run that into terrific figures. And when you sit down and estimate what your maintenance and repairs are going to be, you can run them into a great big figure.

Another very important item that is very controversial here is this vacation pay; when do you deduct vacation pay? Now, the ruling of the Department is that if you have a vacation pay plan which definitely specifies your obligation to make the payment so that at the end of the year you have got a fixed obligation to make a future payment, a payment for that year that is to be paid in the future, an earned vacation that is all earned and has got to be paid for, that is all earned December 31 but is going to be paid for the coming spring, then you can deduct that.

If it is questionable, if you pay it only to the fellow that may be there, or if his rights do not accrue until the time comes at the later period, then you can't deduct it. And this vacation, which year, whether it is in this year or whether it is in the year ahead of the vacation or the year in which the vacation is taken that you have to pay for it, which way you get the deduction is one of the controversial things, and a big item.

Now, that is covered by regulation—and has been for a long time. And what we want to do is just leave that exactly where it was and let the fellow that has the fixed obligation take it as an accrual, the fellow that has the indefinite obligation pay it and get the deduction when he makes the payment. It will all equal out over 2 years, you see. All you are talking about is, Will you pay it this year or next year? You get the deduction either one year or the other.

The CHAIRMAN. But the result is in the nature of a windfall for 1 year, that is the trouble.

Secretary HUMPHREY. If you do it both in one, if you get your actual pay this year and put your estimate back the next year, you get 1 year there.

The CHAIRMAN. There has been some question about prepaid subscriptions to newspapers and magazines, and so forth. How will they be handled?

Secretary HUMPHREY. All there is, is this: If I buy a magazine from you for $5 a year and pay you 3 years in advance, I have gotten $15. That money comes in, the $15 comes in, that is applicable $5 next year and $5 the year after, as well as the $5 this year.

Now, if you put it all in this year, you increase your income this year as against what you are going to have as income in the following years, so that the only difference between accruing it and taking it actually is that you are either going up rapidly or down rapidly; if you are selling the amount of stuff each year there is no difference at all—it will all come out—you will be in exactly the same place over a 5-year period. But if you are actually increasing your subscription it means that you are paying the tax ahead of time as your money comes in, rather than delaying it until future years. On the other hand, if your subscriptions are going down, you are getting the benefit of it. It is simply that difference.

The CHAIRMAN. I have a letter here from Senator Mundt. Maybe one of you could analyze that and make a brief comment.

Secretary HUMPHREY. The difficulty, gentlemen, is this. There is no problem if you eliminate, if you say you are not going to give anybody a double deduction in one year, then the only thing you have got left to talk about in this thing is that we are putting a premium on overestimateing. If you go on what you actually pay, you know that is. If you do it on the basis of estimates, why, it is just human nature that if I could make an estimate, my estimate will be on the high side so that I will take the high deduction, and then maybe 10 years from now or 20 years from now when I go out of business, it will catch up. But in the meantime I am operating on Government-free money.

The CHAIRMAN. What you recommend now is repeal of section 452 and section 462, and revision to where we were before the last Revenue Act was passed?

Secretary HUMPHREY. That is right.

The CHAIRMAN. Now, of course, if it should become desirable to reenact either of those provisions, we could do that.

Secretary HUMPHREY. That is right.

The CHAIRMAN. At the present time it is your recommendation that these two be repealed?

Secretary HUMPHREY. That is right. I know of no way to do it, other than that.

We have worked on many studies, and we have not found any study that does not give a double deduction or raise difficult technical problems—most of the studies give the double deduction over 10 years. Well, you get a tenth in each year, and in 10 years you have a double deduction, and I don't know why one fellow should get a double deduction in 10 years and another fellow shouldn't.

The CHAIRMAN. The Treasury will continue to make the studies, and if need for further legislation on this subject is developed, that can be taken up at some future time?

Secretary HUMPHREY. That is correct. That is not too complicated, Mr. Chairman.

Senator GEORGE. Mr. Secretary, let us take the case where in estimating these repairs, let us say—which the taxpayer is not under any legal obligation to do but which, as a matter of business accounting, he does do, I presume, or should do—suppose after he makes his deductions under this act and actually pays out some money to his stockholders out of capital, and then it turns out that by repeal of these sections that it is taxable to him as an ordinary dividend—that is a situation that might arise. Has it arisen yet?

Secretary HUMPHREY. I don't know. I don't know why it should. It would only be for the 1 year, you see. And I don't see how that could have happened, Senator George, unless somebody went ahead and deliberately did it, because they all had notice of this at the time. Before they could pay any dividend, they knew this.

Senator GEORGE. I think that you will find that some of them have—I don't know whether they should have or not.

Secretary HUMPHREY. If they did it, they did it at their peril, I would say.

Senator GEORGE. In cases like that it was simply distributable as a part of capital, and here it is taxable as an ordinary dividend if this is repealed. You never contemplated in your regulations that future repairs would be allowed anyway, did you?

Secretary HUMPHREY. We never contemplated it, but that is what a lot of people were starting to deduct.

Senator GEORGE. Your regulations didn't authorize that, did they?

Secretary HUMPHREY. No, they didn't. But we were put on notice that our regulations would be attacked in the courts if we attempted to prevent them from doing that. And as we studied this, that is what frightened us, that perhaps this language was such that they might be able to maintain in the courts and get away with it.

Senator GEORGE. I didn't think that was intended at all originally.

Secretary HUMPHREY. Nobody ever intended it, no witness that appeared before this committee, nobody on the committee, and nobody in the Treasury ever had any idea of doing it. We never had any idea of doing the things that people are seeking to do under these provisions, none of you, none of us, ever had any idea.

Senator GEORGE. I certainly had no idea that that would be a permissible practice at all.

Secretary HUMPHREY. That is right. Neither did we.

Senator GEORGE. But if they have acted on it—Senator Millikin raised the question as to whether or not anybody had acted on it—if they have acted on it and made a distribution out of what was supposed to be capital, partial distribution now, and you throw it back to them as a dividend and tax them on that income, I don't know how you are going to make them pay again.

Secretary HUMPHREY. That could hardly occur, Senator, because, in the first place, the only way you could pay capital out is when you have exhausted your earned surplus. And if all your earned surplus is out, unless you are in a company in liquidation, you could hardly pay a dividend out of capital. If you are in a company in liquidation,

then you aren't estimating future repairs. So the particular thing is just, I don't see how you could get a dividend that way.

Senator GEORGE. It may be a partial liquidation, of course, of capital at any time; you could do that.

Secretary HUMPHREY. Not unless you have got your earned surplus gone.

Senator GEORGE. And if you estimated you hadn't any earnings and were making some distribution I am asking you as a matter of fact whether anybody has been caught in that sort of a situation.

Secretary HUMPHREY. We have never heard it, and, practically, it would be almost impossible to occur.

Senator GEORGE. I don't think it would be impossible to occur.

Mr. SMITH. I have not heard of one, but I believe Mr. Williams has heard of one.

Mr. WILLIAMS. I heard of one case in which distribution had occurred early in the year.

Secretary HUMPHREY. You mean, capital investment?

Mr. WILLIAMS. I have heard of it. I don't know if it is true.

Secretary HUMPHREY. I would be interested to see the case, because I don't see how you could do it.

Senator GEORGE. I don't know, Mr. Secretary; I was just asking if that had arisen.

Secretary HUMPHREY. Mr. Williams said he had heard of one. I hadn't heard of it.

Senator MILLIKIN. Mr. Secretary, I had a letter written to me by a constitutent on behalf of a motor express company, and I am quoting what the motor express people wrote him:

> Under H. R. 4725 we observe the prepaid expense section of the Internal Revenue Act would be repealed retroactively through 1955. This has already passed the House and is now before the Senate. It is necessary for our industry to have a loss and damage reserve because we know from experience and incidentally, the Interstate Commerce Commission allows us to owe what past experience will show we have to pass out for loss and damage claims (past experience shows that we have to pay out about 3 percent of our revenue). Under our union contract any man who worked for us longer than 1 year, say, 15 months, is entitled to three-twelfths of his vacation pay for the second year. In other words, it is a direct obligation, and we feel we should be allowed to set it up as a reserve.
>
> Won't you add an amendment on this bill allowing us to set up a reserve for loss and damage claims and vacation pay for the motor-freight industry?

Do you wish to comment on that?

Secretary HUMPHREY. Yes, I would be glad to.

In the first place, as to his vacation pay, if he has a fixed obligation he is taken care of under the regulations as they exist.

In the second place, on the loss and damage claim, I think it is a very dangerous thing, and I think it would be far better and will not hurt this company at all if they get their loss and damage claims as they go along on their actual payments out rather than estimating them ahead, and perhaps building up a reserve on which they do not pay taxes.

I would like to get back to your question, Senator. I don't see how—Mr. Smith can correct me on this if I am not right—but if the fact is that they did pay out a dividend that they thought was capital because of an accrual, and the time is going to come sometime when that overaccrual or that double amount is going to have to be paid as income, sooner or later that is going to be income and they are going to have to pay it.

So the only harm is that they have had to pay the tax on their income this year instead of some other year when it is disbursed at the time this reserve becomes income.

Senator GEORGE. I don't follow you altogether, Mr. Secretary, because you can make a distribution of capital not only in liquidation but in distribution of the capital.

Secretary HUMPHREY. That is correct.

Senator GEORGE. And if in good faith they came along and said: "Here is a law that gives us the right to set up these reserves, and we are going to do it, but our business is not going to expand, it is going to contract, and we are going to make a partial distribution here of capital."

And they pay out to the stockholders, on the theory that it is nontaxable distribution—of course, what you say is correct if subsequently it does wash itself out and they have to make these repairs.

Secretary HUMPHREY. That is right.

Senator GEORGE. That would be true?

Secretary HUMPHREY. Some time or other that will wash out, and then they will have the income, and if they didn't pay on this income now, they will have to pay on it later.

Senator GEORGE. My great trouble is, I didn't think your regulations covered that sort of a deduction anyway, nor was intended to do it. I hoped it didn't but maybe I am wrong about it.

Secretary Humphrey. No; you are not wrong about it. Our regulations did not cover it. We don't believe they were entitled to, and the difficulty is that a lot of people are saying that the courts are going to reverse us.

Senator GEORGE. They might. You can't always tell what the courts will do.

Secretary HUMPHREY. We don't want to take a chance on it.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Of course, the situation could arise where they had distributed some of these funds, but would not the reverse be true, generally, that in the companies that deducted this twice, made this so-called double deduction, they would be reporting less income on their financial statement and would therefore be paying less dividends to the stockholders than they would normally be paying if they had not had this windfall?

Secretary HUMPHREY. That is correct.

Senator WILLIAMS. And the reverse would be true more so than if it weren't repealed?

Secretary HUMPHREY. That is correct.

Senator WILLIAMS. They report less, and automatically pay less dividends?

Secretary HUMPHREY. That is right.

Senator WILLIAMS. I notice several of the companies said that if this were repealed they would have to go back and revise their earnings for last year and they would be reporting larger earnings.

Secretary HUMPHREY. That is correct.

The CHAIRMAN. Senator Flanders.

Senator FLANDERS. I have a letter here, of which you may have a copy, from the Association of Cotton Textile Merchants. And using vacation pay as an illustration, they say that similarly taxpayers having contracts with unions providing for vacation pay have, under

the 1939 code, been allowed to accrue deductions relating to the following year's vacation pay.

This privilege has been generally denied to other taxpayers, that is, to those to whom it is not a documentary obligation, contract. Now, they say:

If section 462 is repealed it appears that the vacation pay problem will become a complete shambles. The Treasury's most recent regulation relating to vacation pay was formulated for the purpose of closing loopholes in section 462. If section 462 is repealed, certainly this latest regulation should also be withdrawn.

Do you see any shambles looming up on the horizon?

Secretary HUMPHREY. No, Senator.

And, even further than that, the regulations that will be applicable protect them on the basis of their past situation every year through the year 1955, so that they will be protected all the way through 1955, the year in which we are now, on the basis of the past, so that nobody is going to be hurt by any change that they may have made.

Senator FLANDERS. Now, speaking generally, if we withdraw, repeal section 462, does that make necessary any reissue I suppose it would of those January 22 regulations?

Secretary HUMPHREY. That is right; it will.

The January 22 regulations are just out. There is no law to support them.

Senator FLANDERS. I judge, although I may have been mistaken, that they assumed that the January 22d would still be in if we repealed 462. And the letter says that the Treasury's most recent regulations relating to vacations pay I assume that is January 22

Secretary HUMPHREY. No.

Senator FLANDERS. You don't think so?

Secretary HUMPHREY. No.

Senator FLANDERS. In any event, you can assure me that his fears

Secretary HUMPHREY. I can assure you that they will be in exactly the same position for the whole of 1955 as they were before August 16, 1954. And all they haven't got is a double deduction.

The CHAIRMAN. Mr. Johnson, we were considering the repeal of section 452 and section 462, reported by the House. Have you any questions?

Senator JOHNSON. No, I pass for the moment.

The CHAIRMAN. Senator BENNETT?

Senator BENNETT. No.

The CHAIRMAN. I would like for the staff to report on this letter I received from Senator Mundt.

Mr. SMITH. This letter, Mr. Chairman, describes the situation with reference to the newspaper of the sort Secretary Humphrey referred to in the answer to your question. It seems to me that this merely restates the same problem. The Secretary's answer already covers the situation described here.

(The letter referred to follows:)

UNITED STATES SENATE,
March 17, 1955.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR HARRY: Inasmuch as your committee has before it legislative proposals designed to correct what newspaper stories have generally referred to as a "blooper" in the 1954 tax law, and since you are understandably and rightfully

studying various proposals for stopping any abuses or misuses of tax concessions written into the Revenue Act last year, I would like to pass along to you a note of warning which has come to me from several of the important newspapers of my own State of South Dakota.

I do this in the full realization that while all of us want to eliminate any wrongful practices which may have developed under the revisions of the Federal law last year, I am sure that none of us want to work a hardship nor do an injustice to responsible and legitimate people in the newspaper field.

Here is the matter to which I refer: Under the revisions made by section 452 of the 1954 Revenue Code newspapers were given the right to report their prepaid newspaper subscription income in the years in which it was actually earned rather than on a cash basis in the year in which it was received. This revision appeared then, and appears now, to be a sound accounting practice and had the support of the House Ways and Means Committee since the revisions grew out of recommendations made by the outstanding accountants of America acting through their official association.

Relying on this 1954 change several of the leading newspapers of my State and I am sure that an examination of the facts will disclose the same to be true of all other areas of the country went to considerable effort and expense to rearrange their bookkeeping practices and bring their accounting systems into accord with section 452 of the 1954 code permitting them to utilize this realistic approach in the reporting of subscription income.

Naturally, these outstanding and responsible newspaper people are shocked and disturbed to learn that some thought is being given to making a retroactive repeal of section 452. Such retroactive action would be in fact a severe penalty to newspaper publishers acting in good faith to adjust their practices to the legislation passed a year ago. It is not the practice in America to pass ex post facto laws nor to penalize private citizens for honestly conforming with laws even though it later develops new or tighter laws are essential.

I sincerely hope that your committee can find a way to plug up the loopholes and batten down the escape hatches which may have developed from the 1954 Revenue Tax Revision while at the same time including language specifically aimed at continuing to permit legitimate newspaper publishers to follow accounting and income tax reporting practices which are consistent with the efficient management of a newspaper business and which permit and require newspaper firms to pay taxes on their subscription income during the year that such income is actually earned.

I am confident that you will have representatives before your committee officially representing newspaper interests and perhaps their respective associations, but I wanted to bring to your direct attention the protests which have come to me from South Dakota publishers against any precipitant or retroactive action now, which would work an injustice upon American publishers.

With best wishes and kindest regards, I am

Cordially yours,

KARL E. MUNDT,
United States Senator.

The CHAIRMAN. Any further questions?

Senator FLANDERS. These two sections, 452 and 462, were put in presumably for a just and desirable purpose. If we now withdraw them, repeal them, how is the purpose, the noble purpose, maintained?

Secretary HUMPHREY. It isn't. We just have not found a practical way. The purpose of the things in the original instance was an attempt to try to get, as far as we can, the taxpayers' books for his corporate accounting on the same basis as for tax accounting, so that the two would be as nearly as possible approaching.

Now, there are some discrepancies in many complicated cases that can't be that way. We tried to ease that situation; we failed because it got complicated and involved a lot of things that were never intended. So we are right where we started. And we tried to gain a purpose; we didn't gain it.

Senator FLANDERS. That is all, Mr. Chairman.

Senator JOHNSON. Could I ask one question?

Mr. Secretary, are there any other provisions of the 1954 law where we have miscalculated, where your estimates have been too low?

Secretary HUMPHREY. No, as far as we know, Senator.

Before you came in I testified that we took up—you perhaps are referring to certain statements that were made of some seventy-odd things. We have gone over those things. We presented them to the staff of this committee, and of the Ways and Means Committee, our joint staffs worked for some weeks on them. I reported all of those to the Ways and Means Committee chairman last week, recommending, following a recommendation of the staffs, that there was nothing of any consequence in any of them.

And the chairman of the Ways and Means Committee made public last Friday the fact that he is in agreement with us that there are in those 70 things no substantial items. They are all things that, for perfection, ought to be done. In other words, there is a semicolon that ought to be a period, and there is a plural that ought to be a singular, and various things of that kind; there is the lack of a cross-reference. And if you are going to have perfection, they ought to be done at some time, but they are nothing that would amount to anything from the point of view of taxation.

Senator JOHNSON. I have primarily in mind the estimate of losses from other provisions.

Secretary HUMPHREY. No.

Senator JOHNSON. This is the principal?

Secretary HUMPHREY. This is the only one that exceeded our expectations that we know of. And if we find any others, we will be right back.

Senator JOHNSON. Thank you.

The CHAIRMAN. Thank you very much, Mr. Secretary.

We have a very distinguished Senator this morning, Senator Gore.

STATEMENT OF HON. ALBERT GORE, UNITED STATES SENATOR FROM THE STATE OF TENNESSEE

The CHAIRMAN. We are glad to have you with us, Senator, and to hear your statement.

Senator GORE. I wish to thank you, Mr. Chairman and members of the committee, for affording me the opportunity to appear here today, and in order to demonstrate my gratitude I will undertake to be brief.

I apologize to the committee for not having copies of my statement for each of them. I am only now completing it, and I am not sure it is completed yet.

The measure before the committee is significant not only because it seeks to close two serious gaps in the tax laws but because it is but the first of many moves the Congress will have to take to correct the so-called errors and inequities of the Revenue Act of 1954.

The Secretary has just referred to the seventy-odd so-called errors. He has just told the committee that their loss in revenue does not exceed estimates. That is not the measure, Mr. Chairman.

The measure of the advisability of eliminating these errors is the equity, not whether it exceeds the estimates of the Treasury Department, but whether or not those provisions of law are equitable, fair, advisable, and sound.

It is interesting to me to note that the term "errors" is consistently applied to the provisions we are asked to repeal. The use of the word "error" would seem to imply that these offensive sections were inserted into the law by inadvertence or mere oversight. That might be true in some instances. In others, though, the only error involved is an error of judgment.

My purpose in appearing here is to request this committee to recognize an error that was intentionally committed and, more importantly, to approve an amendment to close this loophole now.

The tax credit afforded dividend recipients by sections 34 and 116 will, in my opinion, turn out to be the most serious of the many so-called errors in the 1954 code unless eliminated soon.

The arguments pro and con the dividend tax credit and exclusion have been expounded at great length on the floor of the Senate and in the public press, and especially before this committee, so I will not impose upon your time by any detailed discussion of this issue.

However, to clarify my own position and firm conviction in the matter, I wish to state briefly the reasons why I feel that the dividend tax credit is unwarranted.

To begin with, it violates a basic principle of fair income taxation, to wit, taxation according to the ability to pay.

The primary argument of the proponents of the dividend tax credit is that the income received by shareholders in corporations in the form of dividends is taxed twice, once to the corporation and again when received by the shareholders. I submit that this is not double taxation. The tax falls upon the income which the corporation receives in the form of profits, and upon the income which the shareholder receives in the form of dividends. The tax is levied on two separate persons, in the eyes of the law.

To contend otherwise is to ignore the separate existence of the corporation and its owners. Is it logical or consistent to merge the identity of the real and the fictional persons for tax purposes, but permit retention of the distinction between them, otherwise?

No one is compelled to invest his capital in a corporation, yet a glance at the stock market seems to indicate that this form of investment is immensely popular. These announcements are made and corporations are created with full knowledge that a corporation is the product of the law and is lawfully treated as a separate entity.

The corporate form of doing business offers advantages unavailable elsewhere, the best known being the economic insulation which the corporation affords its owners. The shareholders' liability for the debts of the corporate business is limited to their investment.

The perpetual life of a corporation makes possible long-range planning and utilization of heavy property investments to a degree impossible for an individual enterprise. This perpetuity of existence has made accessible to the corporation means of financing which other types of business organizations could not obtain.

The use of the corporate device combined with its offspring, the stock exchange, has enabled the investor, even the smallest investor, to enter or withdraw from business with comparative ease, thus permitting anyone, who so desires, to protect his savings against inflation. This liquidity of investment is one of the most effective of all corporate advantages in stimulating general investment.

An additional and very important advantage of incorporation is the privilege of retaining in the corporation itself sufficient funds for expansion and growth at tax rates far below those which would be applicable in the case of a comparable individual business.

I have recently seen statistics that show that 70 percent of the corporate expansion is made through the retention of earnings.

These are just a few of the more obvious advantages of incorporation. Any person familiar with the intricate nature of present-day industrial and commercial activity realizes that there are many more. For instance, the ability to issue and sell additional equity securities without materially diluting the control of the business, the increased bargaining strength possessed by large corporations in buying and selling, and the concentration and centralized direction of many varied enterprises made possible by intercorporate consolidations—all these advantages, and still others, are available to the so-called small family corporation.

All the advantages and privileges enjoyed by corporations are made possible, let me repeat, solely by the laws of the United States and of the States. Incorporation is not a natural right, or a gift of nature. The corporate person is a legal fiction, and it is illogical to me to say that there is anything wrong, legally, morally, or ethically, in making the enjoyment of this benefit subject to the conditions which the Federal Government or the States choose to impose, particularly the treatment of the corporation as a separate legal entity, which in fact it is.

The method employed in granting this tax advantage is also worthy of mention. The most vocal proponents of the dividend tax relief proposed a credit of approximately 20 percent, at the same time making it quite clear that they considered this simply the first step toward complete elimination of tax on dividends.

I wish also to remind this committee that this provision of law operates, not as a deduction against income but rather as a subtraction from taxes on it.

By introducing this unfair, unsound concept into law, even at a small percentage credit, we have tied around our necks a legislative millstone which, unless eliminated, will plague Congress for years to come. The 4 percent dividend credit against taxes is just the opening wedge, the nose of the camel under the tent. We should strike it from the law now, along with repeal of the so-called blooper.

In closing, I would like to remind this committee of the action taken by the Senate on the only occasion on which it had an opportunity for a clear-cut decision on this dividend credit proposition. I am sure that every member of this committee recalls that Senator Ed Johnson introduced an amendment which had the effect of striking the dividend credit, and exclusion from the law. It was I who caused a rollcall vote on that question. On a rollcall vote the amendment was decisively passed by the Senate, by a vote of 72 to 13.

I respectfully urge this committee to give the Senate another opportunity to express itself upon this question, by adding to the bill now before it an amendment striking sections 34 and 116 of the Internal Revenue Code of 1954.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Gore. We are delighted to have you here today.

Any questions?

Senator WILLIAMS. There is a feeling, perhaps on the part of the Treasury and the committee, that it might be well to restrict this bill to a consideration of section 452 and section 462. However, should there be a decision made to enlarge the scope for consideration at this time, both from the direction of the question you raised on the dividend question and otherwise, I am sure others would come up, particularly the question of revising the present depletion allowances on oil and minerals, and stuff, and so forth.

How would you feel if we enlarge the field of this bill how would you feel about reducing some of these depletion allowances?

Senator GORE. I recognize, Senator Williams, the urgency of repealing the sections embodied in the bill as it is now before the committee. I recognize the inequitable situations which may result from delay, to which Senator George has already pointed an instance. I strongly feel that the Congress should have already given a thorough review of the 1954 act and proceeded to correct many of the so-called errors therein.

I would be sympathetic, even at the cost of delay of this measure, not only to correct this error, but others. However, I do not claim any particular wisdom in that field, nor do I claim to be a tax expert. This particular section to which I have addressed my remarks is so obviously unfair and unsound, in my view, that it should immediately be repealed.

Senator WILLIAMS. Well, I voted with you on this particular measure.

Senator GORE. I know you did, and so did most of the members of this committee.

Senator WILLIAMS. But also, we had before us at the same time the question of whether or not, for instance, the depletion allowance on oil should be reduced from the present rate of 27½ percent. And that has been discussed by the committee and the Congress on numerous occasions, as well as the rates on various minerals.

Would you support a reduction in that, or do you think there should be one, or would you care to give us the benefit of your opinion?

Senator GORE. Senator, I supported your amendment, and am prepared to do so again, if that answers your question.

I do wish to call to your attention, however, that that issue is far more complicated than the instance which I have cited.

Senator WILLIAMS. Well, there is more revenue, you will admit, involved in the question we are discussing than on this particular question.

Senator GORE. Yes. And I address my remarks, Senator, not to the size of the revenue but to the violation of principle; the 4 percent tax credit is not the source of large revenue or loss of revenue, but it is the beginning, and it is an unsound principle that I firmly and sincerely believe should be stricken from the law at the earliest possible moment. And I think this is the time to do it.

Senator WILLIAMS. Well, the question the committee would be confronted with if we bring up one of these other questions, no doubt—in fact, I am sure all of these other questions could come up at the same time. I just wondered how you would feel.

Senator GORE. I do not wish to be in a position of saying that that which I advocate should be considered, Senator. If the committee

takes the position that it will early next year undertake a review of the 1954 Revenue Act and wants to deal only with this matter in this matter in this measure, I am not sure that I should seriously impose my will against that of the committee. But I do plead with the committee to take into advisement the clear-cut issue here involved, the inequity that it involves, and remove it.

The CHAIRMAN. Thank you very much, Senator Gore.

Any further questions?

Senator MILLIKIN. You referred to the taxation of dividends or credit on dividends as an error. That is your opinion, is it?

Senator GORE. I used that word "error" in the context in which it has been used so frequently, both in statements of our officials and in the public press. I think it was a plain mistake. It was not by inadvertence, it was intentionally done.

Senator MILLIKIN. It was not a blooper in the sense of these two sections that we are discussing?

Senator GORE. No, sir.

Senator MILLIKIN. But many of us think it was a very good thing; we don't think it was an error, we think that when you start to remove it from the bill, a lot of people will think it is a very good thing. So it is not a blooper. I don't know of anybody that is defending a blooper.

You are introducing a new thing in this particular today, which is not a blooper but which may involve a difference of philosophy.

The CHAIRMAN. I would like the Senator to define what a blooper is. I have heard that so often, I would like to know what it is.

Senator MILLIKIN. Well, a blooper is anything that the opponent of the particular measure doesn't agree with.

The CHAIRMAN. Thank you very much, Senator.

The next witness is Mr. J. S. Seidman, of the American Institute of Accountants.

Senator CARLSON. Mr. Chairman, I was unfortunately absent at the opening of the hearing, and I want to read the testimony of the Secretary on these two sections. But now I want to say that I am glad that I have the opportunity of hearing this witness, because I know something of his background.

STATEMENT OF J. S. SEIDMAN, AMERICAN INSTITUTE OF ACCOUNTANTS; ACCOMPANIED BY WALLACE M. JENSEN, LESLIE MILLS, AND JOHN P. GOEDERT

Mr. SEIDMAN. Thank you, Senator.

My name is J. S. Seidman. I appear for the American Institute of Accountants, the national organization of certified public accountants with a membership of over 25,000. I am chairman of its committee on Federal taxation. I am accompanied by subcommittee chairmen, Wallace M. Jensen, Leslie Mills, and John P. Goedert.

The bill before you proposes to kill retroactively two provisions that have been acclaimed on all sides as being sound and desirable in principle. One has to do with the allowance of expense reserves; the other with the treatment of prepaid income. Both are a great step forward in bringing tax accounting into line with good accounting.

You are being asked to repeal them for two reasons. One is that they will take too much out of this year's revenues. The other is that they are difficult to administer, because they are written in

broad language, that will bring on a lot of controversy and lawsuits, and may then be found to cover far more territory than was ever originally intended.

We submit, however, that cyanide is a somewhat extreme prescription when castor oil is all that is really needed. We think that both the revenue and the scope problems can be corrected easily and speedily. To deal with the revenue situation, we recommend a 10-year stretchout of the deduction for the expense reserve that should have been allowed in previous years, but wasn't.

As for the scope problem, it can be automatically eliminated by specifying the items of expense reserve and prepaid income right in the law. Your own committee report last year can be used as a guide for the particular items, and the law limited to them.

Let me try to clear the atmosphere a bit here. Strong language has been used about these provisions. Words like loophole, windfall, gross error, and blooper have been tossed about. None of these is in order. No income escapes tax. Nobody gets a deduction twice. The problem, as you will see, is really how best to get a deduction once.

What is involved, and all that is involved, is when items are reported, not whether they are reported. Deductions that should have been allowed in the past have not been allowed. The law as it now stands makes it all good in one year. However, since the Treasury feels that the revenues can't stand such concentrated adjustment, an obvious answer is to dilute the transition by stretching it out over a period.

The House voted for retroactive repeal, and further study. But, since the House vote, there has been a very significant development. We now have a clearer picture of the revenue effect. That was not the case when the bill was before the House. At that time, figures of $1 billion to $5 billion were mentioned. We can now report to you with some assurance that even if the law be permitted to stand as is, with its concentration of deductions, the maximum revenue reduction from 1954 tax returns because of these provisions is not likely to be over $500 million. Of this, $450 million applies to the expense reserve provision and $50 million to prepaid income.

Our estimate is based on samplings of no small proportions. You see, 1954 financial statements became increasingly available right after the House vote. As a result, we got together, through published reports and from our membership, actual 1954 figures accounting for over $8½ billion in tax, or just about half of the total budgeted corporate income tax for the year.

The $500 million applies to 1954 returns only. Some companies have undoubtedly decided to wait until their 1955 returns, before making up their minds whether to go on a reserve basis. On the other hand, our $500 million figure is based on what the companies thought they were entitled to claim, or had to claim, in view of the all-or-nothing provision that is in the law. In most cases the amounts were determined before the Secretary issued his proposed regulations. Under the regulations, many companies are entitled to much less than they thought, and so the $500 million figure is on the high side.

There is another reason the $500 million figure is too high. A further sampling we made shows that 40 percent, or $200 million of 1954 tax reduction, relates to the reserve for vacation pay. With

social and economic trends as they are, and have been, a good deal of that $200 million will stick as a revenue reduction for 1954, or the next few years, even if we go back to the old law.

We want to make it clear that high or low, we would be all for repeal if the $500 million were the result of a double deduction. Furthermore, even as the single deduction that it is, we do not think $500 million, or anything like it, is to be sneezed at. That is why we suggest a 10-year stretchout. The important point is that $500 million is a far cry from $5 billion or even $1 billion that the House thought was involved.

Now that we have given you some of our conclusions, we would like to review with you the support for them. It may be helpful, first, to touch on the accounting principle involved.

Up to 1954, if a businessman, in a financial statement to his bank, showed the same income as he had to swear to in his income-tax return, he could well have landed in jail. Suppose, for example, he owned a piece of real estate, and on December 31 collected $5,000 for 5 years' rent in advance. In his tax return, he had to report the entire $5,000 as income for that year. If he told stockholders, creditors, or the Securities and Exchange Commission that any part of the $5,000 was income for that year, he would be speaking falsely. Obviously, the truth is that it is the next 5 years' income, to be spaced $1,000 a year over those 5 years.

So much on the income side. The expense side of the transaction then created another discrepancy between his financial statement and his income-tax return. If he paid the real-estate agent a commission on the 5 years' rent, though the rent had to be reported immediately, the offsetting commission was not deductible immediately, but only over the 5-year period. Furthermore, the day-to-day expenses of maintaining the building and providing the tenant with services were deductible only as incurred during the 5-year period. That meant that our taxpayer not only inflated the income of 1 year, by having to report in it the $5,000 advance collection of 5 years' rent, but was also reporting deductions in each of the 5 years for commissions and maintenance expenses, with no offsetting income. We thus had a double-barreled distortion.

Let us take another illustration, this one directly from your committee's report last year on H. R. 8300 (p. 306). A company sells an air conditioner for $300. The conditioner costs $200 to make, leaving $100. However, as part of the sale, the company has to guarantee the unit for a year. Experience shows that it costs the company $24 the next year to make good on this guaranty. Therefore, the net profit on the sale of the unit is $76—that is, $100 less $24. If, in the year of the sale, the company did not allow for the $24 liability for its guaranty in its financial statements, it would be overstating its profits. Yet, for income taxes, it had to swear to $100 income in the year of sale, followed by a $24 loss in the next year.

Note that in these illustrations the end result is the same, figuring all of the years involved as an aggregate. But income taxes are not figured that way, and financial statements are not made that way. We have to report on a year-by-year basis. In accounting we do this, and feel we come out with a fair answer, because of a cardinal rule that the revenues of any year, and the costs pertaining to those revenues, must be brought together in the same year, regardless of the time of cash receipts or payouts.

In accounting, therefore, if $5,000 for 5 years' rent is collected in advance, one-fifth or $1,000 is treated as income in each year and matched against that year's expenses. In the air conditioner sale, in figuring the profit on the unit, the $24 that will be spent for servicing the unit in the next year is taken into consideration in the year of sale as an expense reserve.

The old income-tax rules violated these basic principles of sound accounting. The way the income-tax rules worked out, as we have seen, income might be reportable in 1 year and the related expenses in other years, and ne'er the twain might meet. The old rules meant that income was being prematurely reported. They meant taxes had to be paid before the income was actually earned. They meant that small growing businesses, needing every dollar of working capital were especially hard hit because they had to part with some of that working capital, for taxes, earlier than justified.

For many years, we urged the Congress to eliminate this discrepancy and to adopt the rules of good accounting. It was therefore a source of real assurance to find in the revenue revision bill last year, that section 452 dealt with the problem illustrated by the 5-year rent collected in advance, and section 462 dealt with the expense reserve problem illustrated by the service guaranty of the air-conditioning unit. The principle of matching costs with revenues was substantially adopted by the bill.

Your committee's report, at the very outset (p. 2), heralded the fact that—I quote:

> the bill contains many provisions which are important to the growth and survival of small business. These include * * * recognition of business practices for tax accounting purposes, * * *.

In the expense reserve section (462), two things bothered us, and we so reported to your committee. As our views were summarized all in one paragraph, let me read it to you, from page 1313 of the hearings:

> The bill makes great strides in the direction of putting business accounting and income-tax accounting on the same wave length. * * * The transition will bring on some problems, both from a revenue standpoint, as well as the scope of reserves for estimated expenses. For that reason, there is included in our list of recommendations certain cautions and restraints during the gear-shifting period.

Now let me explain the reference to "cautions and restraints during the gear-shifting period." Every important step in progress has a transitional problem. It is the problem of abandoning the old and going on to the new.

Let us take the air conditioner example again. On a unit sold in 1953, the $24 service costs would be expended in 1954. Since that $24 was never allowed as a deduction before, simple justice required it to be deductible in 1954. Then there was the sale of a unit in 1954. Under the old rule, the $24 service costs on this would be deducted in 1955, but under the rule of sound accounting, wisely incorporated in the new law, the $24 service charge became deductible in the year of sale, 1954. That would make a deduction in 1954 of $48.

After 1954, everything would, of course, be straightened out. In 1955 there would be only the $24 deduction applicable to a 1955 sale, and so on each year thereafter. But in the process of getting rid of the old arrangement and going on to the new, the $24 deduction

applicable to the 1953 sale, and the $24 deduction applicable to the 1954 sale, would come together in 1954.

Now if for this one year the revenues could stand it, there would be no problem. After all, changes have been made many times in the tax law that bunched income or deductions in the transitional year. However, their revenue effect was small in the year of change. In the changeover to expense reserves, we recognized that the revenue effect on the 1954 returns was likely to be rather large. Therefore we made the following recommendation (p. 1321 of the Senate Finance Committee hearings):

> To avoid the impact on the revenues in the transitional year where there will be a deduction both for the actual expenses and the estimated expenses, and in order to avoid undue distortion of income, the addition to the reserve should be spread as a deduction over the transitional year and the 2 succeeding years.

In other words, we proposed a 3-year stretchout. Incidentally, Canada adopted the deduction for expense reserves in 1953, and likewise took care of the transition by a 3-year stretchout.

Our recommendation of a 3-year stretchout was not followed. That is understandable. With an estimate, at the time, of revenue loss of only $47 million, there was clearly no need for a stretchout. Unfortunately, this estimate has turned out to be far too short.

Now that we know how much is involved, a 3-year spread is not enough. We therefore propose a stretchout for 10 years as the right way out of the dilemma.

There is ample precedent for a 10-year stretchout. The law provides a 10-year stretchout as a way of catching up with the pension cost for past services. Also, when a taxpayer wants to change from one method of accounting to another, it has been the practice of the Commissioner to require that the effect of the changeover be spread over 10 years.

On a 10-year basis the transitional revenue effect would not be serious in any one year. Here is the way it would work in the air conditioner case. Instead of the two $24 items being deducted all at once in 1954, only one $24 item plus $2.40 of the other would be taken as a deduction in 1954, or $26.40, and the same amount in each of the following 9 years.

I said that when the 1954 bill was before you, we were concerned about two things. One was the revenue situation just described. The other was to keep the expense reserves and prepaid income in proper bounds. That is what I referred to earlier as the scope problem. We need not tarry long with that one. The provisions can automatically be kept in proper bounds by listing in the law the specific items to which they are to be limited.

Thus, through the stretchout and specification, the two things—revenue and scope—that are out of whack with the provisions as they now stand, can be easily corrected without scuttling the fine, necessary purposes the provisions serve.

There is another possible way of dealing with the revenue problem that we would like to discuss with you. I came up in our recent meetings with the staff of the Joint Committee on Internal Revenue Taxation, and so we will refer to it as the staff plan. Colin Stam, chief of staff, invited us to review the plan, and his and our groups met twice on it.

There are many technical phases in the staff plan that we commend to your attention as distinct improvements over the present law.

On the basic problem, where we suggest a 10-year stretchout, the staff plan defers the deduction until the windup of the business or the windup of the reserve, whichever takes place the sooner. Under the staff plan, therefore, there would likely be no immediate revenue reduction caused by the changeover—and there might never be.

Here is the way it would work: Again going back to the $24 air-conditioner reserve, the $24 that applies to 1953 sales would be frozen, and not allowed as a deduction until the business wound up, or the company stopped guaranteeing its product. In 1954, the only deduction would be the $24 reserve on an air conditioner sold in 1954, and so on each year, until the windup.

We think the staff plan is on the severe side. It puts off, to the indefinite future, deductions that taxpayers should have already been allowed. For that reason we cannot affirmatively advocate this part of the staff plan. Nevertheless, we feel that it is so important—for Government and taxpayer alike—that the principles of these two sections be preserved in the law, that if, because of compelling revenue considerations or other factors, it becomes a matter of choice between the staff plan or else repeal, we want you to know that we regard the staff plan as preferable to repeal.

There is another phase about the staff plan that bears mentioning, because of its effect on our $500 million estimate. The staff plan considerably narrows the items that would be allowable as expense reserves or prepaid income. The items would be fewer than your own committee listed in its report last year, or that are contained in the Secretary's proposed regulations. Hence our $500 million estimate automatically becomes too high, if you adopt the scope limitations in the staff plan.

One more point: The House has voted to kill sections 452 and 462, biding opportunity for further study. In all deference, we submit that no further study is needed. Businessmen and accountants have been living with, and properly applying, expense reserves and prepaid income. The wide gap between income tax and good accounting in this respect is nothing new. It has been studied—and decried—for years. Nothing is to be gained by further pondering or delay.

On the other hand, incalculable mischief and impairment of taxpayer morale can be caused by enacting a provision and then retroactively yanking it out, when there is no real need to do so. Let me give you an illustration, from an actual case told me by a fellow practitioner, of the serious harm that retroactive repeal can do. A real-estate owner, in need of funds, got a tenant to prepay 5 years' rent by allowing the tenant a discount. Before the deal was made, the real-estate owner got a tax opinion, readily given him under the present law and before there was talk of repeal, that the 5 years' advance collection would not all be taxed immediately.

Without this assurance in the law the real-estate owner would not have proceeded because the important thing to him was just how much was going to be left for him after the first year's income taxes. Retroactive repeal, requiring him to pay more taxes than he was assured, and pay it all now, is certainly not going to leave a cheerful taxpayer here.

Certainly this much is clear: There is no windfall even in the law as it now stands. The only real problem is the transitional one—how best to cure the ills of the past, when income and deductions were

put in the wrong years, while the present law puts them in their right time slot. Right now, the law takes the medicine all at once. This is too big a dosage for the revenues. We suggest spacing it out in 10 treatments, or, as a last resort, deferring it as the staff plan does.

But we urge you not to kill the patient. He is fundamentally sound, wholesome, and right.

Sections 452 and 462 enable income-tax accounting to come of age. We urge you not to turn back the clock, to the crudities and distortions of the past.

We will be glad to hold ourselves available for sessions with your technical experts to any extent that we can be of help.

The American Institute of Accountants is grateful to you for this opportunity to be heard.

The CHAIRMAN. Thank you, Mr. Seidman.

Are there any questions?

Senator FLANDERS. Mr. Chairman, I noted 1 or 2 points here as the witness proceeded. One is this question of a double deduction to which the Secretary referred 2 or 3 times in the course of his testimony.

On the top of page 7 in your testimony you say, "That would make a deduction in 1954 of $48." Then you go on to say, "After 1954, everything would, of course, be straightened out." Well everything would have been straightened out except the fact of that previous double taxation. That remains on the books as I see it and you propose to get over that by your 10-year spreadout. So it seems to me that the Secretary made his case for the double deduction and you have your remedy. Is that the way to look at it?

Mr. SEIDMAN. Not quite, Senator. I used the term "double deduction" in the sense of allowing something that otherwise a taxpayer would not be entitled to—an inflation of deductions. The convergence of 1954 that brings about a $48 deduction results from the fact that there was $24 that he was entitled to, and had not as yet gotten up to that point. Therefore, in that sense, is not a double deduction. You are right, Senator, in the problem that is posed in that, as a result of the correction, under the present law, two properly allowable deductions come together in one year. Our suggestion is to bridge that problem by spreading out one of the deductions.

Senator FLANDERS. I have one other question.

In connection with the guaranteed servicing of your air conditioner, what happens under the present scheme under this law and the scheme under the old provision? I could see what happens under the old provision, but suppose under the new provisions of anticipating the liability, the liability on the one hand turns out to be $30, and on the other hand it turns out to be $15, what bookkeeping adjustments do you make to bring the anticipated liability in line with the actual situation?

Mr. SEIDMAN. Senator, that problem is no different from what we have already experienced in income tax law. The law has allowed a taxpayer for some time to set up a reserve for bad debts in anticipation of the fact that some accounts may go wrong. He makes a reasonable estimate of this in the year of sale. Adjustments are made from year to year to allow for overages or underages of the past.

Senator FLANDERS. That appears to be very simple.

I have no further questions, Mr. Chairman.

Senator CARLSON. Mr. Seidman, in your statement you refer to the social and economic trend toward vacation pay, and it seems as though your statement at least creates some doubt. You say it creates a loss of revenue even under the rules of the old law. Now I gather from your statement that you feel there will still be an additional deduction?

Mr. SEIDMAN. That is correct, Senator. First, let me indicate what I rather cryptically referred to in the reference to social and economic trends.

During the past 5 or 10 years the general tendency in labor relations has been to give an employee a vested right to a vacation. For example, if he works a month, he automatically becomes entitled to a half day's vacation for that work period, whether or not he is still in the company's employ at normal vacation time, say, in the summer months. That trend I rather anticipate is something that will continue.

Now, here is the way the tax rules work out on this—even under the old law. If a company in any year enters into an arrangement that gives an employee a vested right to his vacation, then in that year the company has two sets of deductions. One is for the actual vacation payments during the summer months for the work since last summer, and the other is for the work from the current summer to December 31. So that, if we say the vacation period is July 1 to July 15, the company becomes entitled to deduct all of the payments in those 2 weeks to employees for their vacation, although it has to do with the work that they rendered from July 1 of last year to July 1 of this year; and then, by reason of the changeover in the contract, on December 31 of this year, the company becomes entitled to deduct accrued vacation pay from July 1 of this year to December 31. In other words, 18 months deductions come together in 1 year even under the old law. There is going to be more and more of this, since more and more vacations are becoming a matter of absolute right.

Senator CARLSON. And then I have one more question.

Assuming that this committee and the Senate concurs in the House's action in repealing these provisions, is there some action that should be taken by this committee and the Congress, to protect many methods of accounting and also the industry and business as a whole?

Mr. SEIDMAN. Yes, Senator. We think that there are many amendments that are required to the bill, if you are inclined—and we hope you are not—to vote in favor of repeal. We have already met with the Treasury, and we have indicated 12 technical amendments that we think must be made to avoid severe injustice and penalty to taxpayers that would be trapped by retroactive repeal. In addition we think there are additional items.

One of them was raised by Senator George this morning—taxpayers who will now find that they have underreported their income because they had been advised that distributions that had been made to them were out of capital, whereas a restatement of the corporate figures as a result of repeal, could mean that the distributions become taxable dividends. These fellows will have underpaid their tax, and become subject to penalty, if the bill is passed in the form now before you.

There is another area that will likewise be affected. This applies to very few taxpayers, but a group of taxpayers that the Congress

has always been anxious to protect. There is a provision in the law that permits unlimited deduction for charity to people who have given for 9 out of 10 consecutive years 90 percent of their income to charity. Those recipients might now find, if retroactive repeal is made, that they have higher income than that originally calculated. They will have, therefore, paid less than 90 percent to charity and, therefore, will be thrown back from an unlimited allowance for charity to the maximum of 20 or 30 percent.

Then there is the situation that I gave in my testimony—the fellow who has in good faith, in reliance on the law as it now stands, taken action that you cannot now possibly undo. In this respect I would like to point this out to you—the Secretary indicated to you that talk about repeal got under way in January or March. But this was January or March of 1955, not 1954. In other words, it was after the close of the taxable year. No one was on notice, or could have been on notice, while these transactions were taking place. Retroactivity, is cruel under those circumstances.

Also we think it is very important that one point that was made by the Secretary be put into the repealer bill—if you have a repealer bill. It is now part of the staff plan. The bill should affirmatively declare that no inference shall attach whatsoever to past administrative practices, rulings, and decisions, as a result of repeal. We have great fear that otherwise some things that are already being allowed administratively, may have to be reversed. For example, there is already, in many cases, the allowance of prepaid income treatment. There is already in many cases the allowance of reserve for vacation pay.

Furthermore, we want to point out to you that if repeal does come you can run into a situation where, instead of a convergence in one year of two sets of deductions, there will be just the opposite and you may come out with no deductions at all in one year. For example, the Secretary has indicated to you that he is going to hold the fort on vacation pay, but only through 1955. Now, what happens in 1956? If you follow the thing through technically you will find that taxpayers who have been allowed to reserve for vacation pay in the past will get no deduction in 1956. They will have accrued up to the end of 1955 the vacation that is going to be paid in July of 1956. But if the employe does not have any vested right to a vacation, there will be nothing to accrue in 1956 when existing rules are withdrawn by the Treasury. There will hence be no deductions whatsoever for vacation pay in 1956. So you can see that one bit of mischief can easily set off another.

We therefore submit to you that if you are inclined at all to go along with repeal, then from a technical standpoint many items will need consideration.

Senator GEORGE. Mr. Seidman, I am glad to note that you and your other associates throughout this country do think that there is some substance in what I suggested; that is, that there might be a distribution in cash out of capital. Based upon this law as it stood, any stockholder might be willing to have a distribution, the directors might be willing to have a distribution out of capital, and to have been willing to have sold their stock in view of the distribution made out of capital, and then find themselves taxed. That is, the corporation will be taxed and the stockholders would themselves be liable for that dividend. That would be an irreparable loss; would it not?

Mr. SEIDMAN. That is correct, Senator.

Senator GEORGE. I do not know whether those cases have arisen, but I can see that some of them may have.

Mr. SEIDMAN. Senator, we can report to you that they have arisen in our own practices, and we would also like to indicate to you that the area of applicability is somewhat broader than the Secretary had the opportunity to present to you. These cases are not limited to partial or complete liquidations. There are many active companies that by reason of past adversity do not have any earned surplus. A distribution made by those companies could be affected by this very problem. Where a company like this has thousands of stockholders, you can see that the administrative job of getting corrected returns from these stockholders can be tremendous.

The CHAIRMAN. Thank you very much, Mr. Seidman.

STATEMENT OF JACQUIN D. BIERMAN, PARTNER, J. K. LASSER & CO., NEW YORK, N. Y.

Mr. BIERMAN. Mr. Chairman, my name is Jacquin D. Bierman. I am a partner in the accounting firm of J. K. Lasser & Co., New York, N. Y. My partner, Howard F. Elin, is with me. Our office represents a considerable number of magazine publishers, both large and small. I am speaking on behalf of these publishers, and, in addition, on behalf of three associations of magazine publishers: The Agricultural Publishers Association, the Associated Business Publications, Inc., and the National Business Publications, Inc.

The Agricultural Publishers Association is an association of 35 farm magazines. Included are both the nationally circulated farm magazines and those devoted to specific States and areas. In a sense they are business publications for farmers. The list of members attached gives an indication of the type of publication concerned, covering every section of the farming population.

The Associated Business Publications, Inc., is an association of 159 business publications, and the National Business Publications of 176 business publications, devoted to serving industrial, institutional, merchandising, and professional activities. Because of the complexity of our economy, you will find business publications which are specifically designed to serve such widely diverse fields as food processing and selling; textiles; electrical, chemical, mechanical, and petroleum products; transportation; and almost every other field which can be imagined.

Since 1940, the principle has been recognized that publishers ought to be entitled to defer prepaid subscription income. By its administrative ruling, I. T. 3369, 1940–1 C. B. 46, the Treasury Department explicitly permitted such deferment, but only in those cases where the publisher had previously used that method of accounting.

The subsequent practice has been conflicting and inconsistent. Publishers which had not previously deferred prepaid subscriptions were required to report them in the year of receipt, under the claim of right theory. In a few cases, the Treasury Department has by ruling permitted a change to the deferral method of reporting the income.

Recently, the 10th Circuit Court of Appeals in the Beacon Publishing Co. case has held that prepaid subscriptions must be deferred

over the period earned. It implies that past years of administrative and judicial interpretation have not been correct. However, this is but one decision out of many. The problem is left more confused and requiring clarification to a larger degree than before.

If section 452 is repealed, the Treasury Department has expressed no intention to change its present practice. In his letter dated March 22, 1955, to the Honorable Jere Cooper, chairman, Committee on Ways and Means, Mr. G. M. Humphrey, Secretary of the Treasury, wrote:

> Furthermore, the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions and other items of prepaid income, either under prior law or under other provisions of the 1954 Code. In other words, the repeal of section 452 will not be considered by the Department as either the acceptance or the rejection by Congress of the decision in *Beacon Publishing Co.* v. *Commissioner* (218 F. (2d) 697, C. A. 10, 1955) or any other judicial decisions.
>
> It is my understanding that the foregoing is consistent with the desire of your committee, with which I agree, that the repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462 had never been enacted.

The Committee on Ways and Means, at pages 4 and 5 of its Report No. 293 (84th Cong., 1st sess.) accompanying H. R. 4725, has stated:

> Your committee in repealing sections 452 and 462 does not intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes, including the treatment of prepaid newspaper subscriptions.

Section 452 represents a major advance in resolving the uncertainties of the past 15 years in the tax treatment of prepaid subscriptions. To repeal that section at this time would only complicate this area still further.

Moreover, section 452 is vitally important to the publishing industry. In these days of high and rising costs, it is imperative that the industry be permitted to utilize accounting principles which correctly reflect income. It is equally important that members of the industry, particularly the small companies, and I can't stress this too much, which are not now on a competitively equal method of reporting taxable income be given that opportunity.

Magazine publishing income comes from two sources—from advertising and from circulation. Advertising income is billed at the time the insertion appears in the periodical. Only in rare instances is advertising paid in advance. Circulation income is from newsstand sales and from subscriptions. Newsstand income is not paid in advance. Subscriptions are either paid in advance, paid immediately upon billing, or in some instances paid over the period during which the subscription is serviced.

Business magazines are not sold on newsstands. Their circulation income is from subscriptions. Some business papers have no subscription income, because their circulation is free or controlled.

Among the business papers with subscription income and among the farm magazines, all subscriptions are either paid in advance or payment is made in full upon billing. General magazine publishers have a larger portion of their subscription income paid during the subscription term.

The publisher assumes a liability to service each subscription over its life. In the case of business papers, subscriptions normally range from 1 to 3 years. For farm magazines, they may run a longer period.

This liability to service extends not only to the publication and delivery, but also to an actual cash refund for the unearned portion of the subscription in the event of cancellation or in the event of cessation of publication.

Subscriptions paid in advance are therefore in the nature of deposits in advance for property to be delivered in the future. They are earned only upon the delivery of such property, namely the magazines and newspapers. To reflect income properly, they should be reported when so earned. This is sound, normal, and conservative accounting practice. It is the proper economic basis for showing current earnings. To tax this income before it is earned is to distort the annual pattern of income.

The expenses, and they are very substantial, of publishing the magazine and of servicing the subscription are not deductible until each issue is published. At that time the income will be earned.

Considering all publishers as a group, it is fair to say that there is a general industry practice, certainly amongst virtually all of the larger companies, where the bulk of such income arises, to defer prepaid subscription income. It has been estimated that 95 percent of all subscription income is now reported on a deferred basis.

To extend the same right to all publishers would put the entire industry on a comparable and equitable basis. It would give the small publisher the right to avail itself of practices which have been recognized as proper for the larger publishers for many years. Section 452 of the Internal Revenue Code of 1954 accomplished this objective.

The present proposals to repeal section 452 stem not from any defect in that section, insofar as it affects publishers. Rather, they are based upon the fear that too large a potential revenue loss in the transition year is involved, and that the section may be diverted to usages which were not contemplated.

Actually, there is no revenue loss involved under section 452 as it affects publishers. More precisely stated, publishers entitled to use a deferral method under section 452 for the first time in the year 1954 have their total tax payments for the period of their existence placed upon a comparable and equal basis with those of publishers which had been permitted to defer under the Treasury's administrative practice. And parenthetically it is obvious that one day all deferred income will be currently taxed income. It might be said that some publishers have been prepaying taxes on subscription income. The change would put them on a current basis.

We estimate that any so-called revenue loss is well within the Treasury Department's original calculations. For all practical purposes, this encompasses the entire publishing industry.

The reason for the small transition year difference is that most of the prepaid subscriptions in this country are already being taxed on a deferred basis. As an illustration, all of the major newspapers in the city of New York report prepaid subscriptions on the deferred method. Furthermore, prepaid subscriptions represent only a small portion of total publishing income. Finally, since many small companies are affected, the average tax impact will be less than 52 percent.

Will section 452 be distorted in its use by the publishing industry? Obviously not. Legislative history and the Treasury practice show that prepaid subscription income was one of the principal items which section 452 was designed to cover. It can be stated almost cate-

gorically, that there is practically no prepaid advertising income which would be affected. Customarily, billings for advertising are sent as the advertisement appears in a particular issue, and the income is reported over the period of the publication. No new questions or twists of interpretation of section 452, as it affects publishers, have even been suggested.

If section 452 is not continued in the law, many publishing companies will be compelled to request permission from the Treasury Department to defer the reporting of prepaid subscriptions. As a matter of fact, there are already on file with the Treasury Department at least 30 such requests. Most of these relate to the year 1954, as well as to 1955.

Treasury Department regulations require that such permission be requested within 90 days after the beginning of a taxable year. The deferral of prepaid subscription income seemed assured by March 31 of 1954, under the then proposed revenue bill of 1954. Consequently, this permission has only recently been requested when H. R. 4725, calling for the repeal of section 452, was introduced.

The Treasury Department may therefore be faced with the decision whether to waive its existing 90-day rule with respect to the year 1954. As an equitable matter, it should do this if section 452 is repealed.

But irrespective of the effect upon the year 1954, timely applications have been made by many publishing companies for permission to change for the year 1955. And in the event of repeal of section 452, it is quite likely that many more permissions will be requested for fiscal years ending in 1955 and for 1956.

If the Treasury Department is to follow its prior practice, as it has stated it would, these requests should be granted.

The record seems clear, so far, that the Treasury Department will not interpret any repeal of section 452 as constituting disapproval of its ruling I. T. 3369. It should likewise be made clear that it will not constitute a disapproval of any of its other ruling procedures affecting publishers. Any disapproval of I. T. 3369 will upset the accounting practices of the entire publishing industry. It would destroy the financial position of many of its members and would make it difficult for them to continue in business. Any interference with accounting practices previously employed will create unwarranted confusion.

Considerable discussion has already been had of the harmful effects of the retroactive repeal—now over 4 months beyond the end of the calendar year 1954—of an accounting provision which so vitally affects the calculation of profits. The effect upon stockholders, creditors, other interested persons, the business policies, plans and negotiations undertaken in reliance upon the law has likewise been brought out.

H. R. 4725 attempts to remedy some few tax problems that will flow from such a repeal.

But there are others which are not presently cured by H. R. 4725, and there are undoubtedly others which will only become evident in the future. For example: Returns filed either on a separate or consolidated basis may represent an obsolete and unwise position if the

law is to be retroactively repealed. It is not clear whether new elections based upon a changed law are available. They should be.

Dividend decisions have been made based upon section 452. And I could assure Senator George that in our own practice we have at least one case where there has been a corporate distribution which was thought to be a distribution out of capital, but which, if section 452 is repealed, will constitute a taxable dividend. The validity of dividend distributions is not governed by the tax law; it is governed by State law. Distributions by corporations can be made under State law although tax law may not treat them as a taxable dividend. A revision of taxable income because of a retroactive repeal of section 452 may create an unwarranted and unexpected accumulated earnings tax problem (sec. 102 of the 1939 Code; sec. 531 of the 1954 Code). There is no tax provision that is a single-edged sword; all tax provisions cut both ways, and a repeal of 452 affects different people differently.

However, the publishing industry wishes to make it clear that it does not oppose the repeal of section 452 merely because of the problems which will arise from such action.

Section 452 reflects tax accounting principles which are valid and proper in and of themselves. They represent a correction of past years of confusion and distortion in taxable income. And to our knowledge there is no dissent to these principles.

We respectfully suggest that section 452 should be continued in the law, certainly as respects the publishing industry, solely upon its own fundamental and basic merits.

We thank this committee most respectfully for the privilege of being heard.

(The list of member organizations referred to is as follows:)

AGRICULTURAL PUBLISHERS ASSOCIATION

MEMBER FARM PUBLICATIONS

American Agriculturist
The Arizona Farmer
The Arkansas Farmer
California Farmer
Capper's Farmer
The Cattleman
Colorado Rancher and Farmer
The Dakota Farmer
The Farmer
Farm Journal
Farm and Ranch—Southern Agriculturist
The Farmer-Stockman
Florida Grower and Rancher
Hoard's Dairyman
The Idaho Farmer
Kansas Farmer
Michigan Farmer
Missouri Ruralist
Montana Farmer-Stockman
National Live Stock Producer
The Nebraska Farmer
New England Homestead
The Ohio Farmer
The Oregon Farmer
Pennsylvania Farmer
Poultry Tribune
Prairie Farmer
The Progressive Farmer
The Southern Planter
Successful Farming
The Utah Farmer
Wallace's Farmer and Iowa Homestead
The Washington Farmer
The Western Farm Life
Wisconsin Agriculturist and Farmer

ASSOCIATED BUSINESS PUBLICATIONS

MEMBER PUBLICATIONS

Advertising Age
Advertising Agency
Air Conditioning and Refrigeration News
American Artisan
American Aviation
American Brewer
American Builder
American Fur Breeder
American Gas Journal
American Lumberman and Building Products Merchandiser
American Machinist
American Metal Market
American Perfumer and Essential Oil Review, The
American Printer and Lithographer
Architectural Forum
Architectural Record
Audio
Automotive News
Aviation Week
Bakers Weekly
Baking Industry
Billboard, The
Blast Furnace and Steel Plant
Buildings—The Magazine of Building Management
Business Education World
Bus Transportation
Canner, The
Chain Store Age:
Administration Edition
Drug Executives Edition
Drug Store Managers Edition
General Merchandise Variety Store Executives Edition
Grocery Executives Edition
Grocery Managers Edition
Variety Store Managers Edition
Chemical Engineering
Chemical Week
Coal Age
Construction Methods and Equipment
Control Engineering
Corset and Underwear Review
Cotton Trade Journal, The
Crockery and Glass Journal
Diesel Power
Display World
Editor and Publisher
Electrical Construction and Maintenance
Electrical Merchandising
Electrical West
Electrical Wholesaling
Electrical World
Electronics
Engineering and Mining Journal
Engineering News-Record
Export Trade and Shipper
Factory Management and Maintenance
Fibre Containers and Paperboard Mills
Fire Engineering
Fleet Owners
Food Engineering
Food Packer
Footwear News
Furniture Retailer
Gas Age
Geyer's Dealer Topics
Gift and Art Buyer, The
Giftwares
Glass Digest
Glass Industry, The
Handbags and Accessories
Heating, Piping and Air Conditioning
Hosiery and Underwear Review
Hospital Management
Hotel Monthly, The
House & Home
Housewares Review
Ice Cream Trade Journal, The
Industrial Design
Industrial Distribution
Industrial Marketing
Infants' and Children's Review
Inland Printer, The
Interior Design
Interiors
Lamp Journal
Linens and Domestics
Lingerie Merchandising
Log, The
LP-Gas
Luggage and Leather Goods
Lumberman, The
Manufacturing Confectioner, The
Marine Engineering
Materials and Methods
Men's Wear
Mining World
Modern Brewery Age
Modern Packaging
Modern Plastics
Motor
Motorship
National Cleaner and Dyer, The
National Petroleum News
National Real Estate and Building Journal
Notion and Novelty Review
Nucleonics
Office Appliances
Office Management
Oil and Gas Journal, The
Pacific Builder and Engineer
Pacific Fisherman
Pacific Laundry and Cleaning Journal
Pacific Work Boat
Packer, The
Paper Sales
Paper Trade Journal
Petroleum Engineer, The
Petroleum Processing
Petroleum Refiner
Photo Dealer
Power

ASSOCIATED BUSINESS PUBLICATIONS—Continued

MEMBER PUBLICATIONS—continued

Printers' Ink
Product Engineering
Progressive Architecture
Poultry and Eggs Weekly
Pulp and Paper
Railway Age
Railway Locomotives and Cars
Railway Signaling and Communications
Railway Track and Structures
Rock Products
Sales Management
Savings Bank Journal
Signs of the Times
Sports Age
Standard Rates and Data Service:
Business Publication Rates and Data
Consumer Magazine Rates and Data
Newspaper Rates and Data
Radio Rates and Data
Starchroom Laundry Journal
Supermarket News
Textile World
Thomas' Register of American Manufacturers
Tide
Timberman, The
Traffic World
Vend
Wastes Engineering
Water and Sewage Works
Water Works Engineering
Welding Engineer
Western Advertising
Western Baker
Western Canner and Packer
Wines and Vines
Wood and Wood Products
World Oil

DAILY BUSINESS NEWSPAPERS

Daily News Record
Retailing Daily
Women's Wear Daily

NATIONAL BUSINESS PUBLICATIONS

MEMBER PUBLICATIONS

Advertising Age
Industrial Marketing
American Gas Journal
American Paint Journal
American Paint and Wallpaper Dealer
American Painter and Decorator
Drilling
National Fisherman
Floor Covering Profits
Fountain and Fast Food
Grocer-Graphic
Rubber World
Premium Practice
Sales Management
Tires TBA Merchandising
Yankee Food Merchant
Boat and Equipment News
The Boating Industry
Progressive Grocer
Finish
Chicago Electrical News
Automotive Industries
Boot and Shoe Recorder
Commercial Car Journal
Department Store Economist
Distribution Age
Hardware Age
Hardware World
Iron Age
Jeweler's Circular-Keystone
Motor Age
The Optical Journal and Review of Optometry
The Spectator
Industrial Woodworking
Maintenance
Plastics World
Power Equipment
Coal-Heat
Concrete
Aviation Age
Construction Equipment
Liquor Store
Mill and Factory
Purchasing
Institutional Feeding and Housing
Construction Digest
Construction News Monthly
New England Construction
Super Market Manager
Voluntary and Cooperative Groups Magazine
Woodworkers Reporter
Arizona Beverage Journal
Dun's Review and Modern Industry
Metal Finishing
Organic Finishing
Electrical Manufacturing
Modern Machine Shop
Products Finishing
Golfdom
Bakers Review
Bottling Industry
Candy Industry
Electronic Design
Boxboard Containers
Electric Light and Power
Electrical Dealer

NATIONAL BUSINESS PUBLICATIONS—Continued

MEMBER PUBLICATIONS—continued

Packaging Parade
American Boxmaker
American Paper Merchant
Paper, Film and Foil Converter
Industrial Laboratories
Heating and Plumbing Equipment News
Air Conditioning Heating and Ventilating
Machinery
Consulting Engineer
Industry and Power
Hardware and Housewares
Jobber Topics
Super Service Station
Butane-Propane News
Gas
Western Metals
Product Design and Development
Western Construction
Western Farm Equipment
Western Industry
Western Paint Review
Maritime Reporter
Meat
Mechanization
Utilization
Medical Economics
R. N.
Mid-West Contractor
Garden Supply Merchandiser
Advertising Agency
American Perfumer and Essential Oil Review
American Printer and Lithographer
Gas Age
L-P Gas
Rocky Mountain Construction
Qualified Contractor
New England Appliance and Television News
New England Electrical News
The Office
Western Advertising
Oral Hygiene
El Mundo Azucarero
Sugar
World Petroleum
Foundry
Machine Design
New Equipment Digest
Steel
Texas Contractor
Rocky Mountain Oil Reporter
Concrete Manufacturer
Pit and Quarry
Printers' Ink
Public Works Magazine
Chemical Processing
Food Business
Food Processing
Jobber News
Constructioneer
Design News
Purchasing News
The Journal of Plumbing-Heating-Air-conditioning Contractors
The Plumbing-Heating-Air Conditioning Wholesaler
Heating-Air Conditioning-Sheet Metal Contractor
Petroleum Marketer
Electrical South
Southern Automotive Journal
Southern Building Supplies
Southern Hardware
Southern Power and Industry
Textile Industries
Southern Appliances
Snips
Southern Beverage Journal
Business Publication Rates and Data
Consumer Magazines Rates and Data
Newspaper Rates and Data
Radio Rates and Data
Contractors' Electrical Equipment
Electrical Equipment
Electronic Equipment
Metal-Working
Plant Engineering
Power Engineering
Industrial Equipment News
Traffic World
Variety Store Merchandiser
Modern Railroads
Appliance Manufacturer
Better Farming Methods
Hatchery and Feed
Poultry Processing and Marketing
Western Underwriter
Modern Materials Handling
Paper Mill News
Transportation Supply News
Insurance Field (Fire and Casualty Edition)
Insurance Field (Life Edition)
Modern Medicine
Petroleum Equipment
Textile Bulletin
Dental Survey
Dental Laboratory Review
The Grain and Feed Review
Western Feed and Seed
American Aviation

The CHAIRMAN. Are there any questions?

Senator BENNETT. Mr. Bierman, you make the comment that most prepaid subscriptions in this country are already being taxed on a deferred basis and earlier on page 5 you estimate that 95 percent of all subscriptions are being taxed on a deferred basis. Actually then

this would have small effect upon your industry as a whole though it might have great effect on individual cases. I would like to clear up 1 or 2 things. Do you know how many or how much of this 95 percent that is now taxed on a deferred basis has obtained that privilege by Treasury ruling as contrasted with having obtained the privilege because they began with it when they instituted their business? I assume that is the only other basis on which they could obtain the privilege.

Mr. BIERMAN. Senator, on page 5 the reference to 95 percent of all subscription income includes income which is received over the term of the subscription and, consequently, is actually reported on a deferred basis because it is received on a deferred basis; it also includes prepaid subscriptions which are reported on a deferred basis. There is no prepaid subscription income which could be reported on a deferred basis without the express approval of the Treasury Department, and under its published ruling only companies which previously used it—probably before 1940—were theoretically permitted to continue using it in the future. There has always been considerable doubt whether a new publisher starting business fresh could start off on the deferred basis.

Senator BENNETT. Well, in your testimony you have indicated that there are as many as 30 applications now pending for permission to go onto the deferred basis, or did I misunderstand?

Mr. BIERMAN. No; that is correct.

Senator BENNETT. Now those people obviously were not operating on a deferred basis before 1940, or were they?

Mr. BIERMAN. Some are companies which started business after 1940 and some are companies which were in existence before 1940.

I should call your attention to this: That most of those applications are on behalf of business newspaper publishers. In the past, subscription income in the case of the business paper publishers was a less significant element of income than it was for general magazines, so it made very little difference years and years ago. But in current years the subscription income has been larger and the problem is now becoming more acute.

Senator BENNETT. I gathered from your testimony that the Treasury on the basis of an administrative ruling has in some cases permitted individual publishers to go from a cash to an accrual basis for reporting their subscription income. Has that been done?

Mr. BIERMAN. That has been done, sir, in a few cases when applications were made.

Senator BENNETT. And are the 30 applications to which you referred comparable to those for which the privilege has been given in the past?

Mr. BIERMAN. Yes, sir.

Senator BENNETT. Do you know whether or not when those particular special privileges were given by administrative ruling that the taxpayer was allowed to double up within the year in which the permission was granted?

Mr. BIERMAN. There were conditions imposed upon the changeover to the desirable system which had the effect of spreading some of the so-called doubling up over a period of years, sir.

Senator BENNETT. Was it a pattern over a period of a specific number of years, or was it different?

Mr. BIERMAN. The ones I know about were on the 10-year deferral method.

Senator BENNETT. And they solved this problem on the basis of administrative decision?

Mr. BIERMAN. Yes, sir.

Senator BENNETT. That is all, Mr. Chairman.

Senator WILLIAMS. In other words, the administration in the past has been doing by Treasury ruling that which the law did not do for everybody when such a ruling was enacted?

Mr. BIERMAN. That is correct, sir; and this was a practice not generally known because the published ruling would seem to deny the privilege of changeover, although on application those rulings were granted.

Senator WILLIAMS. Those rulings which were granted in special instances were not published whereby the information was made available to all taxpayers?

Mr. BIERMAN. That is correct, sir.

The CHAIRMAN. Thank you, Mr. Bierman.

STATEMENT OF PAUL D. SEGHERS, CHAIRMAN, COMMITTEE ON FEDERAL TAX LEGISLATION, FEDERAL TAX FORUM, INC., NEW YORK, N. Y.

Mr. SEGHERS. Mr. Chairman, I am Paul D. Seghers, an attorney of New York City, chairman of the committee on Federal tax legislation of the Federal Tax Forum, Inc., of New York City.

The Federal Tax Forum is a professional, nonpolitical organization of attorneys, tax practitioners and privately employed heads of tax departments of large industrial organizations, and appears before you today to present reasons for retaining in the Internal Revenue Code the existing sections 452 and 562, with suggestions for amendments of these provisions to meet certain valid objections to their present form, and to protest against the unjust proposal in H. R. 4725 that these sections be repealed.

We have been given to understand that only if the Secretary of the Treasury consents, can Congress deny his earlier request that it pass this repealer.

If that were so, our appearance here would be useless and, in all due respect, we submit that these hearings likewise would be useless. We hope, however, that this committee will accept the responsibility of deciding whether the Secretary is right this time, and the heavier responsibility of deciding for itself between fair dealing with taxpayers, as opposed to the mere desire to collect more taxes.

No alternative is possible—if the Secretary is right this time, all of us who appear before you today and those whom we represent, are wrong. This is not a situation where you can discuss a meeting of minds—of bringing viewpoints into harmony. If what the Secretary of the Treasury said this morning—the majority of his statements—were correct, then all of us who are here and all whom we represent are wrong. Somebody is wrong. There is no possibility of both being right.

The position of the Federal Tax Forum is simply stated:

These sections, 452 and 462, do no more than lay down proper rules for the time certain income is to be taxed and certain expenses

are to be deducted. I am pleased to be able to say that the Secretary did admit that in the course of his testimony. If his testimony is analyzed it will be seen that he admits that these sections relate only to the time—only to the timing of deductions and income in the year in which they belong—putting the expenses in the same year as the income. There are no double deductions; it is a false statement to say that there are double deductions. A double deduction means to deduct the same thing twice. Now there is not one dollar of expense which can be deducted twice or one dollar of income which is not taxed properly in the proper time under these sections. So that any statement that they result in double deductions or windfalls is untrue. It is not a windfall to recover what has been unfairly taken away. It has been unfair to tax taxpayers on income which is fictitious, which has been the result in any year in which there have been real expenses incurred and not allowed as deductions. In such cases the income on which the tax is levied is fictitious to the extent that expenses must be paid in connection with earning that income. Hence these provisions, to the extent they reduce taxable income in the first year, only correct past injustices which have resulted from the taxation of fictitious income.

There is no logical or equitable reason for the repeal of these sections. Now, if I say anything that is contrary to what you have heard the Secretary of the Treasury state, again I repeat that one of us is wrong, and I would welcome an opportunity to answer any questions as to any conflict in what is stated here.

Remember that what I am stating is the universal opinion of all competent tax men and all competent tax accountants. There is no conflict in their opinion as to the merits of these statements, and if they are right, then the Secretary is wrong.

The retroactive repeal of these sections would work irreparable damage, not only to those taxpayers who have taken irretrievable steps in reliance upon them, but, much worse, irreparable damage to taxpayer morale and confidence of citizens in the honor, good faith, and fair dealing of Congress.

Now I am here with more warmth in my heart and more warmth in my voice than I would ever have over the question of dollars. I think it is a fact that what is involved is a question of honorable dealing or a repudiation of principles which have never before been repudiated by the Congress. If this is done, how can taxpayers rely on any provision of the law?

If there were any error in the law, if there were any inequity, I would say, "Yes, repeal it." There were no errors. Congress knew exactly what it was doing; the committee reports show it. Congress may not have had the proper price tag on it, but a bargain is not to be repudiated retroactively merely because you find it is a bad bargain in dollars and cents. Did you know what you were doing when you signed the bill? I think that every member of this committee knew exactly what was being done—not the price tag, but what was being done—the correction of past injustices, so that at the end of 1954 no income was to be taxed that had not been earned.

These provisions (452 and 462) would never have been necessary if the basic accounting principles which have been in the law for more than a quarter of a century had been properly administered. This is a fact. These sections would not be necessary if they were not

needed to reconcile conflicting court decisions, and none of those court decisions were obtained without the administration (the Treasury) at that time seeking to collect a tax which it should not have collected. However, we recognize the justification, if not the justice, of the Treasury's fears of difficulties in administration, and we suggest a limitation on the scope of section 462. This limitation would allow the time for deduction to be determined (because that is all these sections do—they determine time for deduction) only in the case of those expenses specifically referred to in the reports of this committee and the House committee in connection with section 462, and those which are listed will be found in the Senate Finance Committee report. They are: sales returns and allowances, cash discounts, repairs and replacements on products sold under guaranty, freight allowances, quantity discounts, vacation pay, and certain self-insured injury and damage claims.

I might interject here that I sympathize with the Secretary in his feeling or understanding that it was never intended that section 462 should allow a reserve for future maintenance and repairs. That evil, which was the only specific one which the Secretary pointed out, could be corrected either by denying the application of section 462 in the case of repairs and maintenance, or a simpler and perhaps harsher method would be to limit its application to only those items which were selected by the Senate Finance Committee in its report as examples of deductions to which it applied. These items (previously enumerated) are not a selection on my part; they are not the selection on the part of any of the practitioners whom I know; this is merely listing those which the Senate Finance Committee itself pointed out as examples of those reserves which should be allowed.

With proper safeguards, there is no reason why income to be earned in the future should be taxed before it is earned. All such income should be treated alike—no favored group should be singled out for favored treatment. The publishing industry has been given favored treatment. I have nothing against what they have obtained, but I do not think that Congress should permit the thing the Secretary spoke emotionally against—allowing benefits to certain taxpayers and not to others. I think that that very principle would justify all that we are here striving for. If anyone thinks he can show any inequity in the provisions we are asking you to retain, after your having carefully conceived and enacted them, I would like to have an opportunity to argue the matter with him.

Finally, we recognize the drain upon the Treasury which would result from correcting all past injustices in a single year, and we recommend spreading the burden over a period of 3 years of more—not because taxpayers obtain any unfair advantage under the law as enacted, but because the Treasury feels it cannot afford to make restitution in a single year.

Further details of our reasons for our recommendations are to be found in the testimony we presented before the House Ways and Means Committee in its formal hearings on H. R. 4725; in the exculpatory resolution adopted by that committee, admitting the fairness of the provisions despite its acquiescence in the request of the Secretary of the Treasury for their repeal, *instanter;* and in the testimony of other witnesses and statements filed with the House Ways and Means Committee, and to be presented here before you.

In conclusion, I wish to express the hope that I will be given the opportunity to respond to any questions raised in the minds of the chairman and other members of this committee by the foregoing statement of the position and recommendations of the Federal tax forum.

We are very grateful for this opportunity to appear here.

The CHAIRMAN. Thank you, Mr. Seghers.

Are there any questions?

(No questions indicated.)

The CHAIRMAN. Mr. William Daley of the National Editorial Association. Is he in the room? I understand Mr. Daley wants to make an insert in the record.

(The statement by Mr. Daley follows:)

STATEMENT OF NATIONAL EDITORIAL ASSOCIATION RE SECTION 452 OF H. R. 4725 BEFORE THE SENATE COMMITTEE ON FINANCE, BY WILLIAM L. DALEY, NATIONAL EDITORIAL ASSOCIATION WASHINGTON REPRESENTATIVE

The National Editorial Association is a national trade association of about 6,000 small daily and weekly newspapers. Many newspapers in our membership are gravely concerned as to the repeal of section 452 of the Internal Revenue Code. This new section had as one of its purposes the removal of a gross inequity which has been inherent in the code for many years. This inequity, which singularly falls most heavily on small publishers, relates to the system of treating income from subscriptions as taxable in the year of payment, even though on a basis of proper accrual accounting, such income is earned only over the subscription period.

We wish to remind your committee that a majority of larger publishers are not affected, but the smaller publishers will again be the victims of the discriminatory practices which have existed for a number of years. The smaller publications are vitally interested in obtaining a provision whereby all publishers may be permitted to report subscription income on an "as earned" basis which, in the final analysis, is the only proper way to treat such income.

It is our view that subscription income was one of the specific items within the contemplation of the Treasury Department and the Congress when section 452 was originally enacted into law. It is, therefore, unlike many items affected by the law which were not originally contemplated and which have caused the agitation for a repeal of the section. Furthermore, the matter of properly including subscription income for tax purposes does not fall into the so-called double deduction area which appears to have stimulated the desire for a repeal of the section. It is simply a matter of taxing such income when it is earned. A review of pertinent sections of the law and decisions rendered seems to us to fully support our position.

The CHAIRMAN. We will adjourn until tomorrow morning at 10 o'clock.

(Whereupon, the committee, at 12:30 p. m., adjourned, to reconvene at 10 a. m., May 12, 1955, in room 312, Senate Office Building.)

PREPAID INCOME AND RESERVE FOR ESTIMATED EXPENSES

THURSDAY, MAY 12, 1955

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

The committee met, pursuant to adjournment, at 10:15 a. m., in room 312 Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd (chairman), Frear, Smathers, Barkley, Martin (Pennsylvania), Carlson, and Bennett.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

We have a very distinguished Senator with us this morning, Senator Douglas.

STATEMENT OF HON. PAUL H. DOUGLAS, UNITED STATES SENATOR FROM THE STATE OF ILLINOIS

The CHAIRMAN. We will be delighted to hear from you, sir.

Senator DOUGLAS. Mr. Chairman, I appreciate the opportunity which you have accorded me of testifying briefly before your committee on the potential loss of revenue which Secretary Humphrey has helped to occasion by the double deduction feature in section 462 of the tax bill of last year, a bill which was drafted under his direction, which he presented to Congress last year, and which he succeeded, with one change, I believe, in section 462, in getting passed.

I shall confine myself to discussing the potential double deductions on reserves on only three types of estimated expenses, namely, first, paid vacations; second, payments by employers into health and welfare funds; and third, payments by employers into pension plans.

I do this knowing full well that probably the estimated deductions for future maintenance and operations costs may loom larger than these large items, but I have no reliable figures on this latter point, and so I shall testify on that feature.

First, paid vacations: I have a copy of a letter from the Acting Commissioner of Labor Statistics, Mrs. Aryness Wickens, addressed to Congressman Zelenko under date of March 3, 1955.

I shall read the two salient paragraphs, and shall ask that the letter as a whole be put into the record as an appendix to my remarks.

The CHAIRMAN. Without objection, it may be admitted.

(The letter is as follows:)

62629—55——4

UNITED STATES DEPARTMENT OF LABOR,
BUREAU OF LABOR STATISTICS,
Washington 25, D. C., March 3, 1955.

The Honorable HERBERT ZELENKO,
House of Representatives, Washington 25, D. C.

DEAR CONGRESSMAN ZELENKO: This is in response to your request of yesterday afternoon to the Department of Labor for information on the number of workers receiving vacation benefits or payments and the dollar payment to these workers for paid vacations.

Surveys conducted by the Bureau of Labor Statistics over a period of years indicate that the great majority of wage and salary workers employed in nonagricultural establishments in private industry receive paid vacations. Typically, most workers receive at least 1 week's vacation after service of 1 year and a substantial proportion of workers receive longer vacations, graduated by their length of service with the employer. Based upon data available, it is estimated that approximately 35 million workers in nonagricultural establishments, excluding Government, received paid vacations in 1954.

No precise data exist as to total expenditures by employers for paid vacations. Using several different bases of estimation, we believe that total vacation payments fell in a range of $3.25 to $4 billion in 1954.

An indication of the prevalence of paid vacation practices in various sectors of American industry is reflected in two types of studies conducted by the Bureau of Labor Statistics. The first of these is based upon an analysis of a large group of collective bargaining agreements covering over 5 million workers. This survey, based upon agreements in effect in 1952, indicated that 94 percent of the workers covered by these agreements received paid vacations. This study is included in BLS Bulletin No. 1142, Labor-Management Contract Provisions, 1952, which is enclosed for your information. We are also enclosing a copy of BLS Bulletin No. 1116, Wages and Related Benefits, 20 Labor Markets, 1952–53, which summarizes the results of Bureau wage surveys during late 1952 and early 1953 in 20 major labor markets. These surveys related to both union and nonunion establishments. Vacation practices for office and plant workers are summarized in table B–2, beginning on page 26. These tabulations provide data separately for manufacturing, public utilities, wholesale trade, retail trade, finance, and services.

I hope that this information will be of assistance to you and if we can be of further service, kindly let me know.

Sincerely yours,

ARYNESS JOY WICKENS,
Acting Commissioner of Labor Statistics.

Senator DOUGLAS. The two paragraphs which I wish to read are as follows:

Surveys conducted by the Bureau of Labor Statistics over a period of years indicate that the great majority of wage and salary workers employed in nonagricultural establishments in private industry received paid vacations. Typically, most workers receive at least 1 week's vacation after service of 1 year and a substantial proportion of workers receive longer vacations, graduated by their length of service with the employer. Based upon data available, it is estimated that approximately 35 million workers in nonagricultural establishments, excluding Government, received paid vacations in 1954.

No precise data exist as to total expenditures by employers for paid vacations. Using several different bases of estimation, we believe that total vacation payments fell in a range of $3.25 to $4 billion in 1954.

And I checked the source that Mrs. Wickens refers to, namely, Labor-Management Contract Provisions, 1952, and BLS Bulletin No. 1116, Wages and Related Benefits, Twenty Labor Markets, 1952–53, Bulletins 1142 and 1116, respectively.

And from the inspection I have made this estimate is reasonable.

The CHAIRMAN. Who is Mrs. Wickens?

Senator DOUGLAS. She is the Acting Commissioner of Labor Statistics, United States Department of Labor.

Now, second, employer payments into health and welfare funds. There is a subcommittee dealing with health and welfare and pension

funds of which I happen to be chairman. And we have been holding hearings on this subject.

And on the 21st of March 23 we brought in a number of experts to discuss the subject in general. And I read from page 77 of the hearings for that day. I asked Mr. Nelson Cruikshank, who is the social security expert for the American Federation of Labor:

Do you have any estimate, Mr. Cruikshank, as to what the total annual value of the health, welfare, and pension plans amount to in unions which are affiliated with the A. F. of L.?

Mr. CRUIKSHANK. It would have to be an awfully rough estimate. Maybe Mr. Kirkland has a better figure.

Mr. KIRKLAND. I have no idea.

Mr. CRUIKSHANK. We know from the studies of the Health, Education, and Welfare Department made, what the overall picture is. We don't have a breakdown of the proportion——

Senator DOUGLAS. I wonder if you could give the overall picture.

Mr. CRUIKSHANK. Something over $2 billion.

Senator DOUGLAS. Is that for pensions alone?

Mr. CRUIKSHANK. No; health and welfare.

Then I asked him:

Do you know how much pensions would be in addition?

Mr. CRUIKSHANK. I do not know offhand. There have been some recent interesting studies recently on that, though, that I think to give a pretty good figure which could be introduced.

And then Mr. G. Warfield Hobbs, the pension expert of the National City Bank of New York spoke up and said:

Something over $3 billion, including the profit-sharing plans.

I will ask that the salient passages be made a part of the record as an appendix.

The CHAIRMAN. It may be done.

Senator DOUGLAS. Now, if this testimony is correct, we have between eight and a quarter to nine billion dollars each year paid out by American industry for paid vacations, contributions to health and welfare plans, contributions to employee pensions. It would certainly seem that these could be claimed by business both for 1954 and 1955, claimed for 1954 and 1955 under 462 (c), and that they can be estimated with reasonable accuracy under 462 (d), paragraph 1, subparagraph (c) of page 159. There may be some question on the pension funds, as I understand it.

Therefore, since these items could be estimated in advance with reasonable accuracy, the Commissioner of Internal Revenue and the Secretary of the Treasury would not be on good grounds in ruling them out.

And while I am not a lawyer, I would say that if they were ruled out, that the companies concerned would have a very good case before the courts with the possible exception of the pension funds. Of course the commerce clearinghouse has listed some of the items which can be deducted.

We do not know how large a proportion of all this will actually be claimed by business, but as I understand it, claims can be filed later so that you cannot judge what the claims in the future will be by the claims to date. And it may be that some are holding back until this situation gets cleared up and they can file their claims at a later time.

And certain large companies have been cited in the financial press as being ready to practice this.

Now, if we can assume that the loss of taxes is 52 percent of the above—and this, I want to say, is a potential loss, not necessarily the actual loss, 52 percent of the 8¼ billion would be 4.3 billion, and 52 percent of 9 billion would be approximately 4.7 billion. This would be reduced somewhat if the pension plans are exempted from section 462.

So that we are dealing with very large magnitudes. And again I want to emphasize that this makes no allowance for the advance estimation of maintenance and operation costs, which some people believe would be the largest figures.

I may say that I have received letters from constituents saying that they filed claims for deductions—I have one very interesting letter from a prominent concern of my State—the contents of which I shall not give, of course, because I regard it as confidential—but they indicated that they were quite well aware of what their rights were under 462, and mentioned, for instance, the vacation payments and anticipated payments in connection with injury to persons, and anticipated claims for shipment damages, and so on, and so on.

That is one of the most specific letters, but the correspondence that I have had indicates that a large number of firms are planning to take advantage of this method.

Now, I don't want to be too hard on Secretary Humphrey; but I would like to point out that apparently he was not awake to what was involved in it—and it was not until after Congressmen Mills and Zelenko this year brought up the matter both in the House Ways and Means Committee and on the floor of the House—that he seemed to take cognizance of the fact, and even then he began to play down the extent of the loss—as indicated in a television appearance of his on March 6 on Face the Nation, in which he denied that the cost would be a billion dollars—I read from page 19 of the transcript—but said that "it might be two or three hundred million dollars."

In short, I do not think the Treasury can be exonerated in this matter, and it is at least guilty of contributory negligence.

And I think the committee should properly scrutinize the recommendations of the Treasury.

I would add just one word, and that is the fact that if by the double deduction for 1954 and 1955 by these items a company can show a bookkeeping loss for the year, then that loss, of course, can be charged against profits of other years, and there will be really a third deduction.

And I have here a photostatic sheet from the Washington Post and Times Herald for Friday, January 28 of this year, dealing with Capital Transit Co., which I would like to read:

Capital Transit Co. doesn't owe Uncle Sam any income tax for 1954, according to the company's preliminary report filed yesterday with the District Public Utilities Commission.

The windfall, a CTC spokesman explained, is due to section 462 of the Internal Revenue Code. This new clause, he said, permits a company to create reserves for estimated expenses related to 1954.

As a result, he pointed out, "operating expenses for the month of December and the 12 months of 1954 have been increased by $631,258 and the company's liability for Federal income taxes due to the 1954 operations has been completely eliminated."

Now, this loss can, under the carryforward and carryback provision, be utilized to reduce income taxes in other years.

That is all the statement that I wanted to make, except one final passage.

Secretary Humphrey has referred to this error of his Department as an "inadvertent" error. And I am perfectly willing to believe that it was inadvertent. But I would like to submit for the record the comment of the Journal of Commerce for Tuesday, March 10, 1955, and ask that it be printed.

Senator MARTIN. Whose comment is that?

Senator DOUGLAS. This is from the Journal of Commerce. It is a newsletter from Washington. I think it is unsigned.

Senator MARTIN. I see.

Senator DOUGLAS. It reads as follows:

"I wouldn't call it an 'inadvertent error'—I'd call it a monstrous error," said the tax attorney reading a George Humphrey pronouncement.

"I guess you could call it the biggest error in our tax history," pursued the longtime capital tax expert. "I don't know of a more monstrous one; do you?"

There is another paragraph, too, I would like to read:

The existence of the loophole has been no secret. One high priced tax service had it tabbed for its clients as a "double deduction" back in May, while the revision bill was still under consideration in the Senate; and the American Institute of Accountants even spelled out the dynamite lurking in the language for the Senate Finance Committee.

Since then it seems each time a tax accountant called on a business client, a new deduction gimmick was born.

What seems incredible in retrospect is that the storm took as long to gather and to break as it did.

And what seems even more incredible is that the Treasury apparently thought until as late as a week ago, one week after Congressman Zelenko spilled the beans on the House floor, that it could hush the matter up by ignoring it, shutting its eyes and ears to it—and by relying on tight, tough regulations governing application of the offending sections.

I ask that the whole article be printed.

(The article referred to is as follows:)

[From the Journal of Commerce, March 10, 1955]

NEWSLETTER: TAX REPORT—WINDFALL PROVISION HELD BIG ERROR IN TAX WRITING

WASHINGTON.—"I wouldn't call it an 'inadvertent error'—I'd call it a monstrous error," said the tax attorney reading a George Humphrey pronouncement.

"I guess you could call it the biggest error in our tax history," pursued the long time capital tax expert. "I don't know of a more monstrous one, do you?"

The bizarre story of sections 452 and 462 of the Internal Revenue Code of 1954 has had tax circles here buzzing the past fortnight—and the Treasury in a first-class flap, or tizzy. Even an untutored, lay eye described the scene there early this week as "everyone running around like chickens with their heads cut off."

The storm over the superboner broke at a particularly inopportune moment for the administration (and conversely for the majority party in Congress) because of debate on the $20 tax credit proposal passed by the House but running into trouble in the Senate. It gives the Democrats the opportunity to sneer, "Ah, so you are ready to hand out from 1 to 5 billions to the corporations without worrying about budget balacing, but when it comes to giving $20 tax credit to the little guy, that's fiscal irresponsibility?"

TREASURY EMBARRASSED

So the Treasury has been keenly embarrassed.

The existence of the loophole has been no secret. One high-priced tax service had it tabbed for its clients as a "double deduction" back in May, while the revision bill was still under consideration in the Senate; and the American Institute of Accountants even spelled out the dynamite lurking in the language for the Senate Finance Committee.

Since then it seems each time a tax accountant called on a business client, a new deduction gimmick was born.

STORM LONG IN BREAKING

What seems incredible in retrospect is that the storm took as long to gather and to break as it did.

And what seems even more incredible is that the Treasury apparently thought until as late as a week ago, 1 week after Congressman Zelenko spilled the beans on the House floor, that it could hush the matter up by ignoring it, shutting its eyes and ears to it—and by relying on tight, tough regulations governing application of the offending sections.

That this was not likely to prove a rewarding policy began to be clear over the weekend when House Democrats began lining up heavy artillery and zeroing in on 462.

PRESSES FOR REPEAL

The Treasury thereupon hastily called for outright repeal, apparently realizing that any attempt at patching up the section by spreading revenue loss over several years would play into the hands of Democratic strategists who would enjoy nothing more than to prolong the service life of this inviting target.

The Treasury decision, if belated, is under the circumstances the wisest course for the country as a whole, some unbiased experts feel. It was instantly acted on by leaders of both parties in the Ways and Means Committee, with identical Cooper and Reed bills for repeal.

Historians meanwhile noted that this was not the first discovery of a loophole as wide as a whole backfield in the new tax code.

One legislative rush job of patchwork already accomplished has been to give back to narcotics enforcement agents their main enforcement weapon, inadvertently left out of the narcotics tax chapter of the code.

Senator CARLSON. Did I understand the Senator to say who that tax expert was?

Senator DOUGLAS. No; he was anonymous.

Senator CARLSON. It was an anonymous statement by someone?

Senator DOUGLAS. That is correct. But the Journal of Commerce is a reputable publication, and their reporters, I find, are held to high standards of accuracy.

Senator CARLSON. I have a very high regard for the Journal of Commerce, and I am surprised that they didn't put the expert in; that was my only point.

Yesterday, Mr. Chairman, we had a witness, Mr. J. S. Seidman, who represented the American Institute of Accountants. And I believe he stated that they have a membership of 25,000.

I take it that the distinguished Senator from Illinois knows of that organization?

Senator DOUGLAS. Yes, sir.

Senator CARLSON. Mr. Seidman testified—and I am going to read just a section of it here—he said they had made a study of several hundred corporations, and that—

we now have a clearer picture of the revenue effect—

speaking of sections 452 and 462—

that was not the case when the bill was before the House. At that time, figures of 1 billion to 5 billion were mentioned. We can now report to you with some assurance that, even if the law be permitted to stand as is, with its constant

reductions, the maximum revenue reduction from 1954 tax returns because of this provision, is not likely to be over $500 million. Of this, $450 million applies to the expense reserve provision and $50 million to prepaid income.

The next paragraph reads:

Our estimate is based on samplings of no small proportions. You see, 1954 financial statements became increasingly available right after the House vote. As a result, we got together, through published reports and from our membership, actual 1954 figures accounting for over $8.5 billion in tax, or just about half of the total budgeted corporate income tax for the year.

I take it, then, from the statement of the Senator this morning, that he wouldn't place much credence in the statement submitted yesterday to this committee.

Senator DOUGLAS. Well, I don't wish to question Mr. Seidman's integrity at all, or his competence in his field. I would like to point out, however, the fact that some companies have not yet claimed the deduction does not mean that they will not claim it in the future. Now, there is some evidence to indicate that a number of companies have been holding back until they see what happens. I believe there is a public statement by the great General Motors Corp., the largest company in the United States, to that effect.

And therefore I would say that this survey of Mr. Seidman's though undoubtedly made in good faith and undoubtedly accurate so far as it goes, does not indicate at all what the ultimate cost may be, it is simply on the basis of what present claims have been made.

Senator CARLSON. The Senator mentioned a vacation item, and of course that was discussed at some length with Mr. Seidman. I asked him about it myself, because I thought it was of great importance to this committee. But if I understood his testimony correctly—and I do not have the transcript this morning—he stated that this could be used even under existing law.

Senator DOUGLAS. It could be used, but the question is of double deduction, because as you know, there is a provision in 462 that you can deduct not only the actual amount paid out in 1954, but the estimated cost in 1955. I mean it is the same principle involved here as in the Ruml plan, that when you shift forward your basis for computing income, you have the question of what to do with the intervening year. What made the Ruml plan so attractive in its original form was this forgiveness principle of a year; and it was compromised, as you well know, by half forgiving, half collecting.

Now, on these items, as you know, Senator, you can make the deductions not only for 1954 but if you can estimate them with reasonable accuracy for 1955 you can make that deduction, and then thereafter the deduction is for the ensuing years.

It is a one-shot affair, true. But that one-shot windfall may be very considerable.

The CHAIRMAN. Any further questions?

Senator MARTIN. Senator Douglas, in your study of this situation, have you come to a conclusion in your own mind as to what the loss of revenue may be?

Senator DOUGLAS. No, I have not had access, naturally, to Treasury figures. And my estimates here are on potential loss, that is, I did not testify as to how much of this will be claimed by business. But assuming that business has access to competent tax advice—and there are all kinds of tax lawyers and tax services which see to it

that they do—I would say that these are the limits to which they could approach.

And again I want to emphasize that I have not mentioned the item of maintenance and operating expenses. I am not competent to speak on that subject. But I have been working in the field of health and welfare payments and pension payments. And these estimates by Mr. Cruikshank and Mr. Hobbs seem to be accurate. And Mrs. Wickens' estimate on vacations checks with the published studies that I have been able to get.

The CHAIRMAN. Do you favor the repeal of the two sections retroactively?

Senator DOUGLAS. I do, sir.

The CHAIRMAN. And you feel that repeal of them will prevent loss to the Treasury?

Senator DOUGLAS. Yes, sir. I regret that due to the errors of the Treasury that innocent firms have been led to expect that they will get these favors, and then to have them yanked away from them seems cruel, I appreciate that. But that is not our fault.

Senator BENNETT. Does the Senator feel that the Finance Committee had no part in this process, or the Senate itself, and is blaming the Treasury for this entire activity? We studied this problem very carefully, and on the basis of our best judgment decided that the Treasury's estimate of $47 million was fairly accurate.

Now, we underestimated it, so did the Treasury, but I think we in the Finance Committee and we in the Senate must assume our share of that responsibility.

Senator DOUGLAS. First, may I speak about the House. The House is the body which initiates revenue bills, and under the Constitution it is presumed, at least to take an even greater share of responsibility on money bills than the Senate. I have checked with members of the House Ways and Means Committee, and I believe this is what happened, that the Democratic members, at least, of the House Ways and Means Committee were not permitted to see the draft of the bill as a whole before it was introduced, that indeed as they came into each day's session they were given proof sheets of the chapter under consideration, they were not allowed to take those proof sheets home, they were collected after each day's session and taken away from them. There would be verbal explanations, but they were not permitted any opportunity to study them.

So I think that we can say that the bill was ramrodded through the House without an opportunity for the House Members, and certainly not the minority Members, to study it.

The CHAIRMAN. That certainly wasn't true of the Senate. Senator Millikin was then chairman, and he gave every Democratic Member, as well as every other member of this committee, every opportunity.

Senator DOUGLAS. I am speaking of the House.

The CHAIRMAN. And the bill including this and other provisions, was before this committee nearly 90 days. There were at least 60 days of hearings. So far as this committee is concerned, as a Democrat, I can say every member had the fullest access to all the information.

Senator Millikin gave every possible consideration to the members of this committee allowing opportunity to bring out every fact.

Senator DOUGLAS. I was merely testifying to the situation on the House side. As I said, I don't know that Secretary Humphrey can

be charged with exclusive blame, and I did not so charge him. But I do say that there were certain bad errors down in the Treasury.

The CHAIRMAN. Isn't it a fact, that errors have been made and acknowledged, and repeal of the sections would wipe the slate clean?

Senator DOUGLAS. May I say that I don't believe in keeping books in politics, and I don't believe in being vindictive at all. But I would like to point out that the Secretary was very reluctant to admit the errors, and it was not until Congressman Zelenko raised the matter in the House in a very sharp speech, and Congressman Mills of Arkansas, who is recognized as a tax authority, raised the issue in the committee, that Secretary Humphrey acknowledged it.

I think it is likely that he displayed the same reluctance in admitting the error that a cat does when it is pulled by the tail backward across a thick rug.

Senator BARKLEY. I was not a member of this committee at that time, but is not this true, that throughout the history of this country the plain purpose of having a Senate is so that it may correct the errors of the House?

Senator DOUGLAS. We like to think that.

I may say that in justice to Mr. Seidman, he did submit a memorandum—and this is very much to his credit—a long memorandum on specific weaknesses in the act.

On page 1321 of the Senate hearings he had the following point of sections 462 (a) and 462 (b), 462 (d)—I will read the suggestion on 462 (a):

> To avoid the impact on the revenues in the transitional year, where there will be a deduction both for the actual expenses and the estimated expenses, and in order to avoid undue distortion of income, the addition to the reserve should be expressed as a deduction over the transitional year and the 2 succeeding years.

That is, he proposed forgiveness, but forgiveness spread over 3 years instead of taking 1 year.

Senator BENNETT. He did not propose forgiveness. He proposed spreading out the impact of the transition over 3 instead of 2 years.

Senator DOUGLAS. Well, as I understand it, when you shift from a current year basis to an anticipated year you have the problem of what you are going to do as you shift from 1 year to the other. And 462 now provides that it can be taken all at once.

Senator BENNETT. That is right.

Senator DOUGLAS. Now, I don't see that you reduce this amount if you take it in 3 bites rather than 1. The amount of pie which you swallow is the same in each case, except that you don't take as large a mouthful the first year.

Senator BENNETT. That is right. But this committee had before it another problem in which it took the same position. We undertook to step forward the payments of income taxes by corporations into the year in which they were earned and where previously they had always been calculated at the end of the year. We allowed no forgiveness. So American corporations are now—over a period of 5 years, isn't it, Mr. Chairman?—they are now absorbing an extra year's total income tax.

Senator DOUGLAS. What section was that?

Senator BENNETT. I can't remember.

It was an attempt to offset the effect of the Mills bill. And we are actually imposing an extra year's income tax on all American corpora-

tions, giving them 5 years in which to make the adjustment. And it seems to me that there is some equity in the fact that if you are going to make that kind of an imposition you should also consider giving them an opportunity to make this other transition. I think it might have been better if it has been spread rather than coming in full year.

Senator DOUGLAS. I am not competent to speak on this other provision, Senator, that you raise. What you said is undoubtedly true, since you have said it. It is, however, extraordinary that the Treasury did not anticipate the loss of revenue which is going to result, because clearly their estimate of $45 million was too low.

Senator BENNETT. Forty-seven.

Senator DOUGLAS. Forty-five in the House and forty-seven over here.

Now, it certainly did not correct the staff in the estimates which the staff made. And in Secretary Humphrey's testimony before the House Ways and Means Committee this year he again used the $47 million figure, as is indicated by a press release which Congressman Jere Cooper issued and which I quote:

> For some time some of us on the committee have been concerned about the operation of these provisions and the resulting loss of revenue, due to the fact that these provisions were rumored to be creating windfalls for affected taxpayers. During the appearance of the Secretary of the Treasury before our committee on February 21, 1955, when we were considering the extension of the present corporate and certain existing excise tax rates, Mr. Mills (Democrat, Arkansas) asked the Secretary about section 462, and in particular whether or not it was true that there might be a considerable loss of revenue involved in this provision. The Secretary replied that the estimate for the revenue loss for all the accounting provision changes, including section 462, was still $47 million, as originally estimated, and that he was not aware of the fact that there were reputed to be windfalls under this provision for taxpayers. Mr. Mills then asked the Secretary to investigate the rumored windfalls and report to the committee immediately if he discovered that they might exist.

I am not interested in excoriating Secretary Humphrey. But I do think that indicates that there have been gross errors by the Treasury.

Senator BENNETT. May I put into the record that part of the law to which you refer found in section 6016 which requires corporations to begin to estimate their income taxes early as September 15 of the year in which it is earned. And that has the effect of forcing the payment of 1 full year's income tax, spread over a 5-year period. And it is double taxation to that extent.

Senator DOUGLAS. I am not competent to testify on that, Senator,

Senator BENNETT. In other words, we are facing a situation here in which what the Secretary himself calls double deduction turns up in one part of the bill and double taxation turns up in another part of the bill. And we more or less took them from the same point of view.

Senator DOUGLAS. Could you make an estimate of the relative magnitude of the double taxation as compared with the double deduction?

Senator BENNETT. Well, it is one-fifth per year for 5 years of the total annual income tax.

Senator DOUGLAS. I mean the size of the double tax levied as a result of 6016 as compared to the double deduction granted under 462.

Senator BENNETT. Let's go back. It is one-fifth for 5 years of the total income tax due. Now, if the total income tax collected is $18

billion or $20 billion, then it approaches—it isn't that high, because there are certain deductions and certain exemptions, but it is a very substantial and sizable burden we put on the American corporations in a process which is just the reverse of the process to the Senator is objecting, and which the Secretary has objected to.

Senator CARLSON. In view of the fact that I brought Mr. Seidman's name into this this morning, I have a copy of a letter written to the chairman under date of April 8. And I think it is important that we get some of these figures into this record. As a matter of fact, our committee has the responsibility of determining, at least on averages, I assume, the estimated loss on this. And I want this letter to be a part of the record.

(The letter referred to is as follows:)

AMERICAN INSTITUTE OF ACCOUNTANTS,
New York 16, N. Y., April 8, 1955.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: The Finance Committee presently has before it H. R. 4725 to repeal retroactively sections 452 and 462 of the Internal Revenue Code of 1954. Repeal has been urged because of huge anticipated revenue loss. Figures ranging from $1 billion to $5 billion have been mentioned by Congress. But they were admittedly unsubstantiated guesses. We know that you would prefer to have a much firmer basis than that to deal with legislation of such seriousness and magnitude.

We have, therefore, made a survey dealing with the actual figures that cover about one-half of the corporate income and corporate tax of the country. The results of the survey may be summarized as follows:

Total corporate organizations surveyed	13,668
Total net income (before Federal tax)	$19,263,460,000
Total provision for taxes	$8,391,365,000
Tax provision without sec. 462	$8,593,135,000
Difference in tax attributable to sec. 462	$201,770,000

We have no reason to believe that the figures in respect to the other half of the corporate income and corporate tax would be any different from the half that we did survey. That leads to the conclusion that for all corporations the reduction in 1954 tax attributable to section 462 would be $400 million. So far as the unincorporated enterprises are concerned, very few of them are eligible for section 462. But, in our opinion, a generous allowance based on data in the Statistics of Income (compiled by the Internal Revenue Service) would be another $100 million. The total tax impact of section 462 on 1954 returns for all taxpayers would, therefore, be approximately $500 million.

There are a few things about these figures that should be pointed out:

(1) The $200 million is the amount based on what the corporations thought they were entitled to claim as deductible expense reserves. The proposed regulations limit the scope of the deductions considerably so that if, as we recommended to the Ways and Means Committee, the law were modified to adopt the interpretation of the regulations, the $200 million would be cut down. This, in turn, would proportionately reduce the $500 million estimate.

(2) One of the most significant expense reserves in the $200 million figure is vacation pay. A substantial part of that amount will be deductible even without section 462. The $200 million figure—and hence the $500 million estimate—should therefore be reduced to that extent. We are making a supplemental survey right now to see whether we can provide you with reliable figures in that respect.

(3) The $200 million figure applies to 1954 returns only. It may be that many companies decided to defer until their 1955 returns determination about going on the expense reserve basis since under the proposed regulations they have that right. In terms of the total transitional impact, the $200 million is to that extent subject to increase if 1955 returns are also to be considered.

(4) The figures cover only section 462. We do not believe that section 452 can have any significant impact on the current revenues. We are now trying to gather data on this.

(5) We believe the figures represent a fair cross section. Of the 100 largest manufacturing companies in the Nation (as listed by National Industrial Conference Board) the figures contain 51. The other companies are in all sized brackets, activities and geography. We have gone over the figures with Mr. Colin Stam, Chief of Staff of the Joint Committee on Internal Revenue Taxation and some of his colleagues. At their suggestion, we are breaking down some of the figures by size categories.

(6) The figures cover 13,668 "corporate organizations." The number of separate companies involved is much higher. A parent and all its subsidiaries were considered as one company in the 13,688 figure. In this respect, you may be interested in knowing how we obtained our figures. We analyzed the published 1954 reports of approximately 600 companies. We also asked our membership and State CPA organizations all over the country to submit similar data on unpublished reports. In other words, these figures are all authenticated from company reports obtained either from their published figures or from their certified public accountants.

We hope the study may be helpful to you. We believe you now have a much better perspective with which to approach H. R. 4725. We shall also promptly submit to you the supplemental data on which we are now working.

Everyone seems to agree that sections 452 and 462 are important, desirable provisions to bring income into line with good accounting. As in all progress, transitional problems arise. We recommended that by a 10-year stretch-out and limitation on the scope of the provisions the transition can be smoothly effected without substantial revenue impact. Whether that particular approach be used or any other that will accomplish the same end, we do hope that your committee will be able to see its way clear to the retention of the basic principles now that the revenue effect can be the better appraised.

Respectfully,

J. S. SEIDMAN,
Chairman, Committee on Federal Taxation.

Senator CARLSON. But I just want to mention these few items. The Institute of Accountants surveyed 13,666 corporations. The total income before Federal taxation was $19,263 million. The total provisions for taxes was $8,391 million. The total provision without deductions, now section 460, was $8,593 million, or a difference in tax attributable to section 462 of $201,770,000. And on that basis I assume Mr. Seidman made his statement yesterday where he said it would run into $400 million or $460 million. I just wanted the record to show these figures so that the others may see them.

Senator DOUGLAS. I am glad you asked to have that letter in the record. Like many other letters, I received a copy of it from Mr. Seidman. And I want to make the same comments again that I made originally, that the fact that the double deduction has not been claimed is not a proof that it will not be claimed in the future, that is the point I would like to make, that there is a hidden liability here which, if 462 is continued, is likely to explode.

Senator CARLSON. In other words, this tax provision without section 462 is $8,593 million plus, and then the difference in tax attributable to section 462 was $201,770,000. I assume from the Senator's statement he didn't think that this is all of it.

Senator DOUGLAS. I would say that there is a very great danger that it is not all of it. And the figure I gave, I was very careful to say, was the potential liability, the potential loss. And tax services are quite ubiquitous these days. And if the loophole is continued, shall we call it, I think you will find a good many firms taking advantage of it in the future that did not say they had taken advantage in the questionnaires that they returned to Mr. Seidman. I don't question the accuracy of his questionnaires.

Senator CARLSON. The point I want to make on that is that we have a great number of accountants, and we depend on them for

corporations and individuals to work out their tax returns. And if they didn't do a good job we wouldn't hire them.

Senator DOUGLAS. You are a sophisticated man, and you know that figures in accounting tables do not tell untruths, but they sometimes do not tell all the truth. Isn't that true?

Senator BENNETT. In other words, the Senator wants to be on the record as having no faith in the American system of accounting?

Senator DOUGLAS. Not at all. You make me say things that I didn't say at all. I simply said that these figures are undoubtedly accurate so far as they go. But they cannot find out whether or not these firms in the future will make claims under 462 which can be applied to the 2 years in question. This is just a progress report.

The CHAIRMAN. Any further questions?

Thank you very much, Senator.

Senator DOUGLAS. Thank you very much for your courtesy.

The CHAIRMAN. The next witness is Mr. William J. Grede, of the National Association of Manufacturers.

STATEMENT OF WILLIAM J. GREDE, NATIONAL ASSOCIATION OF MANUFACTURERS, MILWAUKEE, WIS., ACCOMPANIED BY JOHN C. DAVIDSON, DIRECTOR, GOVERNMENT FINANCE DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

The CHAIRMAN. You may proceed, sir.

Mr. GREDE. Mr. Chairman and members of the committee, my name is William J. Grede. I am president of Grede Foundries, Inc., of Milwaukee, Wis. I appear in opposition to H. R. 4725 on behalf of the National Association of Manufacturers in my capacity as chairman of its taxation committee.

Before I proceed with the statement I have prepared I would ask your permission to make a brief comment on Senator Douglas' testimony if I may.

The CHAIRMAN. Proceed.

Mr. GREDE. In regard to the vacation pay that Senator Douglas has talked about, the figures that he cited are not indicative of the amounts that would be actually claimed under section 462. In many cases some of these amounts are already accrued under prior law. And in others the amounts would not be reserved at all, because not clearly attributable to the income of the taxable year. The only reliable estimate of the revenue loss overall is that which the American Institute of Accountants has made. And that covered half of all corporate business, and included all of the items which they had claimed or planned to claim in accordance with Mr. Seidman's testimony, and as Senator Carlson referred to.

Now, under health and welfare plans, amounts are subject to deduction as actual contractual liabilities and not as reserves for some expected, estimated expense. No one has suggested that 462 be applied to health and welfare as they are clearly covered by other sections. And the same way with pensions, they are covered by other sections of the code not involved in 462.

Now, the proposed regulations specifically exclude the pension payments. Corporations get the deduction for the amounts actually paid. And even in the case of payments for past service liability, these are spread out over 10 years. And this fact provides some prec-

edent for what we are recommending. It seems that the American Institute of Accounts' figures are the most reliable we have seen. And after all, these sections are to apply to the reserves only for those expenses which might be related to a particular taxable year. And there can be no willy-nilly deduction for any future reserve, as we would expect the Revenue Department to review any reserves that are set up.

It seems that Senator Douglas' figures have no relation to the operation of section 462. And it would seem to me that they would in no way disturb the accuracy of the Institute of Accountants' estimate as to what these losses might be.

Senator SMATHERS. Mr. Chairman, on that point I wonder if I might make a comment.

It has been called to my attention that insofar as the vacation pay is concerned that this method of accrual in figuring out the future years has already been pretty well established and will be continued anyway through 1954. And here in this bulletin from the Internal Revenue Department on that particular point of vacation pay where the issue was up in 1949, there are two paragraphs which I would like to read which I think may help to clear the record a little bit:

> Accordingly, it is held (1) that for each of the calendar years 1941 to 1947, inclusive, the employer shall accrue at the end of such year, as a deduction for Federal income-tax purposes, the amount of its liability to make vacation payments to nonoperating employees—

in that particular case it was an issue between the union and the railroad—

> in the succeeding taxable year, which amount should equal the amount actually paid in such succeeding taxable year.
>
> With respect to the calendar year 1948 and the subsequent calendar years, there should be accrued and deducted for Federal income-tax purposes a reasonable estimate, based on the best information available, of the employer's liability to make vacation payments to operating and nonoperating employees during the succeeding taxable year. Any adjustment of these accruals in succeeding taxable years to conform to the actual liability may be treated as "overlapping items" as provided by section 29.43-2 of regulations 111.
>
> The principles set forth herein are not confined to cases involving railroad corporations, but are applicable to all taxpayers employing the accrual method of accounting for Federal income-tax purposes who, under labor union agreements, have become liable for vacation pay.

And I understand now the Secretary has issued a further order that irrespective of what has been done with 462 (c) that this policy will continue through 1955.

So I think that there is some considerable merit in what this gentleman states here.

Mr. GREDE. I would also like to say, Mr. Chairman, I have with me Mr. John C. Davidson, who is the director of the Government Finance Department of the NAM.

Now, with your permission, I will move on to my testimony.

NAM is a voluntary organization representing a cross section of American industry. Of its membership of approximately 20,000, some 83 percent have less than 500 employees. Our taxation committee of 300 members is representative of the membership at large. At a meeting held on April 13, this committee voted unanimously against compromising the principles underlying sections 452 and 462.

Let me first say that we were sympathetic with the predicament of the Treasury in March, when it became clear that the revenue effect

of sections 452 and 462 would be considerably in excess of the Treasury's original estimate. We could not subscribe to the drastic proposal for hasty repeal. However, we in common with other witnesses before the House Ways and Means Committee felt it our responsibility to make suggestions for limiting the scope of the section and spreading the revenue effect over a period of years, without abandoning or violating the fundamental principles involved.

Our opposition to H. R. 4725 is based on two principles.

The first principle concerns retroactive taxation. Retroactive taxation, even within a tax year, is inherently unsound and unfair. Retroaction extended to a tax year already past makes a mockery of the precept that citizens have both the right and the duty to conduct their affairs in conformance with existing law. Repeal or emasculation of the sections at this time would amount to retroactive taxation going back to January 1, 1954.

The point has been made before you that taxpayers had ample notice that sections 452 and 462 were in jeopardy before they made final policy determinations based on their existence. Actually, the fact is that from the time, last July, when this committee reported out its amendments to the 1954 code, taxpayers had been planning to avail themselves of the opportunity afforded to get on a current basis of proper statement as regards income and expenses. They had no notice that the sections were in jeopardy until the repeal request was first made on March 7, 1955. The business books for 1954 were generally closed, and tax returns had been completed and in many cases filed.

In addition, various corporate actions, such as declarations of dividends, payments into pension and profit-sharing funds and charitable contributions, had been taken; year-end statements to stockholders, creditors and others had been issued; and stock transactions based on reported earnings had taken place in equity markets.

Against this situation, you have heard the point of view that continuation of these sections in the law would involve extensive administrative burdens and complications to the Treasury Department, and that at least a partial justification for repeal stems from taxpayer reaction to the proposed regulations which were issued by the Treasury Department on January 22.

In answer to the first point, I strongly suggest the possibility that the complications confronting the taxpayers upon repeal of these sections would far exceed any which the Treasury Department would endure by their retention.

In answer to the second point, I assure you that American industry, as represented by the National Association of Manufacturers, was quite satisfied with the proposed regulations, and under date of February 18 transmitted to the Commissioner of Internal Revenue a letter which made only minor suggestions for revision. I think this point is most important, as I do not believe that all business taxpayers should be penalized for the attitude of a few individual taxpayers or groups in regard to the rules for applying the contested sections. Moreover, I am sure that most if not all taxpayer groups who appeared before the House committee and who will appear before this committee are quite willing to have the law interpreted in accordance with the proposed regulations.

The second principle goes directly to the issue before us. There seems to be no doubt but that section 452 will stand or fall with 462, so I will direct my remarks to the latter section.

There has been some dispute and misunderstanding as to just what is the principle underlying section 462.

Business accounting is an applied science, with the mission of recording the economic facts and results of business operations. The proper test of an accounting method or procedure is whether it conforms with the economic nature of the underlying transaction. The principle of section 462 is found in its economic justification.

An economic transaction involves both income and expenses. If it were practical to conduct business operations without regard to time, the net income from any given activity would not be determined until every expense in connection with that activity had been incurred and accounted for. For example, the satisfaction of a warranty on a product 5 years after it is sold is just as much a part of the expense of producing and selling the product as are direct wages paid during production. This basic economic consideration, however, has to give way to the demand for terminal points in accounting, both for corporate fiscal and taxpaying purposes. Thus, we have the corporate fiscal year and the tax-paying year. To a considerable extent, the potential inaccuracy of yearly reporting is offset by accrual accounting. There are other offsets, such as the carryback and carryforward for tax purposes of operating losses.

To achieve sound accurate reporting of the economic results of a business in a given report year, accrual accounting should reflect all expenses related to the production and sale of particular goods and services. When the amount of such expense is known with reasonable accuracy and the liability is fixed, there is no problem. The difficulty arises when the liability is not fixed in a legal sense but there is reasonable certainty that expenses will be incurred. To take care of this kind of situation, business accounting has long used the reserve method, which is nothing more than setting aside in a reserve that part of the current year's income which is estimated to approximate the amount of expense which will be subsequently incurred with respect to such income. It is just as sound and right to recognize such reserves for tax purposes as it is for corporate purposes.

In one form or another, compromises have been circulated which would force taxpayers who elect the reserve method to drop out 1 year's deductions in order to meet the charge of double deduction or windfall. Both the compromises and the charges, which constitute the only case for repeal made before you yesterday, imply that the reserve procedure is correct, but only as to the future.

Actually, of course, the correctness of the reserve procedure is not a matter of time. The intention of section 462 is to permit the taxpayer to deduct currently all expenses as they actually occur. Certainly, the intention was not to deny the taxpayer any deductions for expenses actually incurred, but was to correct the unfair procedures of the past under which these expenses have not been deductible in the years to which they applied. Such a denial would be repugnant to the principle of the economic relationship of income and expenses. The dropping out of 1 year's expenses would not be approved or condoned by public auditors if extended by a company to its corporate accounts. Nor should it be entertained by you as having a rightful place in the Nation's tax system.

The charge of double deduction obviously is without foundation. In no case would the same expense be deducted twice. Expenses relating to past transactions are just as real as those relating to current or future income, even though the deductions occur in the same year. They are just as real taxwise as they are corporatewise. Contrary to the charge of unfairness, catching up for overpayment in the past is the only means for establishing fairness between all taxpayers.

The charge of windfall is equally without justification. Instead of unjust enrichment, the tax adjustment under section 462 provides the measure of the inequity of prior law in failing to permit deductions as they accrue. The greater the total amount of adjustment for all taxpayers, the greater is the inequity which was corrected by section 462. Should the section be repealed, or emasculated, the results would be a windfall to the Government because the Government would then be in the position of overcollecting taxes, as it was before enactment of the 1954 code.

Our insistence on maintaining the principle underlying section 462 does not mean we believe the section as written is perfect. In the testimony delivered before the House Ways and Means Committee by Mr. KITENDAUGH, we recognized the need for amendment, which might include (1) requirement that the reserves be recorded on the books, (2) prohibition against deducting reserves for maintenance and repairs of the taxpayer's own property, and (3) other exclusions set forth in some detail in the proposed regulations.

We also gave our support to having the discretionary authority of the Secretary of the Treasury under the section extended to the extent necessary as regards items qualifying for reserve treatment. We do not withdraw from this expression of support, but we have been impressed with the view that the situation would be better handled by a clear delineation of coverage in the statute and supporting committee reports.

In common with other witnesses, the great emphasis of our testimony before the House committee was on spreading out the tax effect of section 462. We suggested 5 years. Other witnesses suggested from 3 to 10. Both the witnesses, and the committee, were handicapped by the lack of authoritative data on the range of the revenue loss involved.

We feel that this informational void served to detract from the practical nature of the spreadout approach. This committee is in a position to consider the merits of a spreadout without fear of subsequent embarrassment. The fears and confusion which existed in mid-March have been dissipated by the American Institute of Accountants' estimate of a $450 million loss in fiscal 1955. Even this estimate is probably high because it includes amounts which would be prohibited under the proposed regulations and also amounts for vacation pay which might be allowable now or later without regard to section 462. The spreadout under these circumstances would so minimize the revenue aspect as to make it unimportant in the relation to the overall magnitudes of Government spending and taxing in any one year.

I need not tell you of the improved revenue picture in the current year. H. R. 4725 as now drafted would not affect the revenues in the remainder of the present fiscal year.

In fact, I urge you upon the view that the changed revenue situation, as compared with that which seemed to exist in early March, should be given the greatest weight in your deliberations. At that time, no one had a very precise idea as to what the revenue drain of these sections would be and the thinking seemed to be that there at least was the possibility of a very substantial revenue effect in the fiscal year which ends on June 30. Now, however, we know that isn't so—the revenues this year will be better than the Treasury estimated in January; and, as I said, H. R. 4725 would bring nothing back into the Treasury this year. It would seem to me that this situation alone would provide sufficient grounds to justify your reaching a decision on the merits of the matter.

The question posed by H. R. 4725 is one of deciding whether revenues in the next fiscal year should be increased by repeal or emasculation of sections 452 and 462, forcing taxpayers to pay into the Treasury an amount equivalent to the 1954 tax adjustment. Such a course of action should be firmly rejected. We can assume from experience that the relation between estimated and actual revenue and expenses next year, or in any year, will vary more than the sum involved here.

The spreadout, of course, would permit some inflow of revenue to the Treasury next year, without violation of fundamental principle. In our testimony before the House committee, we suggested that the spreadout be effected by deferring 80 percent of the tax adjustment for 1954 to be recoverable as a credit against tax liabilities for the succeeding years. As a practical operation, this would mean that taxpayers would be obliged to temporarily remit back to the Treasury 80 percent of the adjustment. Then, in their returns and payments for the four following taxpaying years beginning with 1955, taxpayers would take a credit equal to 20 percent of the original adjustment.

We have been mindful that one objection to the spreadout would be administrative inconvenience and expense. This cannot be avoided as far as the taxpayers with relatively large incomes and reserves are concerned. It might be feasible, however, for the Government to forego the spreadout in the case of taxpayers whose tax adjustment under these sections is relatively small, say up to $5,000 or even $10,000. Such procedure would at least have the practical virtue of avoiding unnecessary further irritation of small-business taxpayers.

I express our appreciation for the privilege of testifying before you.

The CHAIRMAN. Thank you, Mr. Grede. You have made a very clear statement.

Any questions?

Senator BARKLEY. Mr. Chairman, I was not here yesterday, I had to be at another committee, and I didn't hear the testimony of the Secretary of the Treasury. Is he recommending that we adopt the House bill as it passed?

The CHAIRMAN. He did, without change.

Senator BARKLEY. I have had a great many letters in regard to the retroactive feature of this legislation. And I don't quite understand the difference between the Treasury and those gentlemen who are opposed to the act in regard to that.

Is that the main or chief objection you have to it, that it has a retroactive effect, or is that only one of the objections?

Mr. GREDE. It is one of our objections. I think it is a serious defect in lawmaking to pass a tax law this year that taxes back into

1954. Our principal objection, however, is the surrender of the principle that tax accounting and corporate accounting should be identical and realistic.

Senator BARKLEY. Would all the corporations have to pay the tax retroactively if the bill is passed?

Mr. GREDE. Not all corporations. According to the Institute of Accountants' survey, the figure they have, there is something over $200 million that would be captured if this were repealed.

Senator BARKLEY. In other words, they would, to use a vulgar expression, have to cough up that much money and turn it into the Treasury which they have already been excused from doing under these sections.

Mr. GREDE. That is right, which they were excused from paying under the law in existence at the time they filed their tax return.

Senator BARKLEY. Assuming that this committee would pass this bill out, recommend it for passage by the Senate in some form, and eliminate the retroactivity, what then would be your further objection to the bill except on the general principle that you like it as it is and want to continue the principle involved in these two sections? Would there be any great inconvenience?

Mr. GREDE. Well, to those corporations who have used sections 452 and 462, to repeal it effective only in the future would mean no inconvenience to them as they have already compressed 2 years in one—unless, of course, repealing it would provide that they could set up reserves in this year, then it means that in this year they would not get the reduction for the expenses applicable to this year's operation. For those corporations who did not use sections 452 and 462, they would lose forever the advantage that the other taxpayers had in 1954.

Senator BARKLEY. If this bill is passed just to repeal these sections, we revert to the law before the passage of the 1954 code unless it is changed in the future?

Mr. GREDE. That is right.

Senator BARKLEY. We go right back to the old custom?

Mr. GREDE. That is right.

Senator BARKLEY. You object to that, you want to have this principle involved here in the legislation for the future?

Mr. GREDE. That is right.

Senator BARKLEY. And also to have the retroactivity eliminated. That is all.

The CHAIRMAN. Any further questions?

Senator BENNETT. I would like to ask one question.

Senator Douglas implied or testified that it was his opinion that many corporations were waiting for a better opportunity to get a great windfall out of this program, they did not make the shift in 452 but claimed—they are going to make the claims in the future. If the bill were amended, what would be your reaction to an idea that people who chose to go on the reserve method now on the straight method would have to make a choice within a limited period of time so that we force the total effect of this thing into a fairly limited period of time?

Mr. GREDE. Well, of course, first of all, Senator Douglas more or less assumed that the law permitted corporation to just willy-nilly set up reserves.

Senator BENNETT. That is right.

Mr. GREDE. But, of course, the Treasury Department has never permitted that. We have the situation of the bad debt reserve, for instance, where we had a similar situation which permitted the setting up of reserves. But in the examination of one's income tax returns, we can't set up a reserve that is completely out of proportion to past experience. And don't forget that the examination of the return is made some 3 or 4 years later, when the revenue agent has an opportunity to look at the thing in retrospect. So there is no willy-nilly setting up of reserves, they must be related to the expenses of the particular year.

Now, to limit the time within which taxpayers might get themselves established with their books and their taxes on the same basis I think is not too important. I think it is desirable to probably limit the time and get it thoroughly established. But the important thing is that taxpayers be permitted to charge against their income the expenses that apply to the particular year in which the income was earned.

Senator BENNETT. I see that principle, but I can also see that a person who objects philosophically to this approach, saying, well, under the present bill a man can wait until he has got a year of substantial deductions, and he can make his choice in a year in which it would give him an added benefit, and so I have had the feeling that maybe if we amend the bill we might put something in the bill which would require a decision within a fairly limited period, and then shut off this open-end situation.

Mr. GREDE. We would have no objection.

Senator BENNETT. You made a comment about the double deductions, and made the point—which I think is very important—that even under 462 the same taxpayer may not deduct the same expenses twice. Is that your definition of double deduction?

Mr. GREDE. Well, that is right. Senator Douglas makes this appear as if your double deduction means that you are getting the deductions twice, but actually you are simply getting your books, your tax books, in line with your corporate books. Now, if you are going to make the tax laws apply with equity, it does mean that these expenses which we have not in previous years been allowed to charge in the year to which they apply—especially if you are going to limit the year of charge—must be compressed into 1 year. So that the double deduction impression arises from the fact that you then deduct in 1 year the expenses, the actual expenses paid in that year, even though they relate to the previous year but were not allowed for tax purposes in the previous years, plus the expenses that apply to the current year, and then from then on you deduct only the current year's expenses.

Senator BENNETT. Well, if you follow a corporation out to the end of its existence it gains no advantage out of this law, isn't that true?

Mr. GREDE. That is right. Of course, it seems to me that it gains no advantage under any circumstances. But it does mean that, to offset the double deduction argument, if the expenses that apply to this year are set in reserve, then when the corporation is eventually liquidated any part of that reserve that is not used up again becomes income and subject to tax.

Senator BENNETT. That is all, Mr. Chairman.

Senator BARKLEY. Let me ask this question. Ordinarily the repeal of any existing law takes effect from the date of the repeal, and this

House bill merely repeals these two sections. How do you interpret that to mean that they go and repeal them on the day which were enacted unless there were something in the bill to make do that? Ordinarily a bill is not retroactive, but only takes effect on the date of the repeal. How do you interpret that in this case?

Mr. GREDE. Senator, I am not a law maker or a lawyer, but my understanding is that we are repealing a section of the 1954 code.

Senator BENNETT. May I call the Senator's attention to page 2 of the bill, lines 12, 13, and 14.

Senator BARKLEY. I see. I hadn't had a chance to study this bill, and I was not here at the time it was passed. I see that it does positively repeal it as of August 16, 1954.

Senator BENNETT. With respect to all taxable years after December 31, 1953. So the repeal affects all taxable income accumulating after January 1, 1954, and therefore applies——

Senator BARKLEY. Applies to the whole year of 1954.

Senator BENNETT. The whole year of 1954.

Senator BARKLEY. That is all. I was mistaken about that.

The CHAIRMAN. Any further questions?

Thank you very much, Mr. Grede.

The next witness is Mr. Herbert Danne, of the United States Chamber of Commerce.

TATEMENT OF WILLIAM HERBERT DANNE, WASHINGTON, D. C., ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

The CHAIRMAN. We are glad to have you, sir.

Mr. DANNE. My name is William Herbert Danne. I am a certified public accountant of the District of Columbia and a member of the committee on taxation of the Chamber of Commerce of the United States.

The chamber is a federation of some 3,100 State and local chambers of commerce and trade associations with an underlying membership of over 1,600,000 businessmen, large and small.

The chamber urges modification of H. R. 4725 to retain section 452 of the Internal Revenue Code of 1954 in its present form, and amend section 462 to define its scope more clearly and provide a method of transition to use of this new tax provision which will minimize revenue loss in the transitional year or years.

Sections 452 and 462 of the Internal Revenue Code of 1954 were devised to permit the matching of income items and expense items for tax purposes in accordance with sound accounting conventions. The Secretary of the Treasury and the chairman of the Committee on Ways and Means have indicated agreement with the broad principles involved in these sections.

Section 452, relating to prepaid income, has no long-range effect on the revenues since it merely permits the deferral of taxation of moneys received in advance until a later year or years in which the income is actually earned. Clearly, revenue considerations do not require the repeal of this provision standing alone, and I shall therefore direct my statement principally to section 462.

Within the last 60 days a popular but erroneous conception of section 462 as a provision involving a double deduction has been

given wide circulation. I wish to emphasize that section 462, in its present form, involves not a double deduction but a bunching up in the year of transition of two proper deductions—the current expenditure for the taxable year and an estimated amount to be added to the reserve at the end of the year to cover future expenditures attributable to income of the year.

The idea of bunching up of deductions is neither novel nor revolutionary. In fact, it has received the blessing of the Treasury Department in at least two areas. For 30 years the revenue laws have permitted accrual basis taxpayers so electing to deduct additions to reserves for bad debts as an alternative to deducting losses on specific accounts receivable. In the year of transition to use of a bad debt reserve the taxpayer has always been permitted to deduct not only the reserve but also the amounts actually charged off.

For more than a decade taxpayers having obligations under union contracts to grant vacations in the subsequent year have been permitted to deduct in the current year amounts accrued with respect to the next year's vacation expense. In the year of transition such taxpayers have been permitted to deduct not only the amounts accrued with respect to the subsequent year's vacation expense but also the amounts expended in the current year for vacation expense.

The CHAIRMAN. You refer to "taxpayers having obligations under contracts." Suppose a corporation made a contract with some employees that are not under the union, wouldn't they still have that same privilege?

Mr. DANNE. They would, but that has been a developing and producing thing. The original permission to accrue vacation pay had to do with railroad union contracts going back to the early forties. It has expanded since.

The CHAIRMAN. I think they should have the same privilege if they made an agreement with their employees in specific cases.

Mr. DANNE. Mr. Chairman, that actually has been the position of the Secretary of the Treasury under the administrative ruling which has been suspended effective as of the end of 1955. But that was an extension of the original policy.

Does that answer your question?

The CHAIRMAN. Yes.

Mr. DANNE. To put it another way, section 462 of the Internal Revenue Code of 1954, in its present form, merely belatedly permits taxpayers to adopt for tax purposes accepted accounting practices which they have followed in their financial accounting for many years.

It appears, therefore, that the principal objection to section 462 is the effect on the revenues in the year of transition. Admittedly this is a significant and important objection. However, in the light of the more careful study of the question which has been possible in the 2 months which have elapsed since the issue first arose, we can gage the revenue impact on a more reasonable basis.

As previous testimony has brought out, and as Senator Carlson mentioned earlier in today's session, a study made by the American Institute of Accountants of the actual 1954 financial data of corporations accounting for approximately one-half of the estimated reserves from corporate income-tax sources, leads to an estimate of something under $500 million. This admittedly would be a sizable current revenue loss. However, the national chamber believes that the

revenue impact can be mitigated by spreading the additional deduction which would arise as a result of the transition over a period of years, possibly 5 years.

In the latter connection it should not be overlooked that the Revenue Code of 1954, in placing certain corporations on a pay-as-you-go basis, has adopted a period of 5 years in which to mitigate the doubling-up effect on the payment of taxes.

Another objection to section 462, in its present form, is based on concern over the authority of the Treasury Department to limit the types of reserves which might be established under its provisions. It is the view of the national chamber that this situation could be handled by amending section 462 to provide either for definite types of reserves to be established in accordance with generally accepted accounting principles or, in the alternative, to grant the Secretary of the Treasury clear discretion and authority to specify by regulation the types of reserves to be covered. Ample precedent for such a grant of discretion is to be found in the treatment of consolidated returns wherein, under the Internal Revenue Codes of 1939 and 1954, the regulations promulgated by the Secretary of the Treasury are given the full force and effect of law.

The national chamber has one further suggestion. It is our belief that a contributing factor to the potential loss of revenue under section 462 in its present form is the all-or-none requirement whereby a taxpayer wishing to invoke the section must include in his election all items deemed to be covered by the section. It is our view that many taxpayers would prefer to apply the provisions of section 462 on a selective basis, limiting the election to only some of the types of reserves apparently contemplated by the section. We therefore suggest that section 462 (c) (2) be amended to give the taxpayer the option to limit his election to one or more of the allowable types of reserves contemplated by the section.

In conclusion, we urge that no final decision be made in favor of absolute repeal of section 452 or section 462 without adequate appraisal of the extent of the inequities which would be suffered by taxpayers who in good faith and in justifiable reliance on those sections in their present form have taken irrevocable steps.

We recognize that H. R. 4725 as passed by the House of Representatives includes some saving provisions calculated to alleviate the effect of the retroactive repeal of sections 452 and 462. However, these provisions care for only one side of the problem, the relations between the Treasury and the taxpayer.

On the other side are the relationships as between the taxpayer and a third party. These would include, but would not be limited to, the real property owner who has accepted substantial advance rentals, the corporate taxpayer who has declared dividends—possibly from capital account—or entered other types of commitments, or the contractor who has made irrevocable penalty type contracts.

We can hardly believe such inequities to be the intent of the Congress or the Treasury.

On behalf of the national chamber as well as my own behalf I appreciate the courtesy extended to me by the committee in giving me this opportunity. I hope the suggestions have been constructive and of assistance.

The CHAIRMAN. Thank you very much.

Any questions?
Senator Martin?
Senator MARTIN. No.
The CHAIRMAN. Thank you very much.
The next witness is Thomas L. Preston, general solicitor, Association of American Railroads.

STATEMENT OF THOMAS L. PRESTON, GENERAL SOLICITOR, THE ASSOCIATION OF AMERICAN RAILROADS, WASHINGTON, D. C.

The CHAIRMAN. Mr. Preston, please proceed at your pleasure.
Mr. PRESTON. Thank you, Mr. Chairman. I will identify myself at the outset for the record. My name is Thomas L. Preston. I appear on behalf of the Association of American Railroads, an unincorporated, nonprofit association of class I railroads which includes in its membership railroads operating more than 95 percent of the road mileage in the country and realizing more than 95 percent of the gross revenues of the railroad industry as a whole. My position is that of general solicitor, and my headquarters are in Washington, D. C.

It is our belief that enactment of H. R. 4725 to effect retroactive repeal of sections 452 and 462 of the Internal Revenue Code of 1954 would result in serious injustice to the railroad industry, and that there is no occasion for repeal of these sections, at least so far as they affect the railroads, whose accounting is prescribed and supervised by the Interstate Commerce Commission.

In his prepared statement which formed the basis of his testimony before the Ways and Means Committee of the House on March 10, 1955, and again in the course of his testimony before you yesterday, Mr. Chairman, the Secretary of the Treasury pointed out that the original objective of these two sections was simply to conform tax accounting with business accounting, and that it was never intended that these provisions would result in any substantial loss of revenue as a result of windfalls to taxpayers.

He added, however, and I quote from his prepared statement, that "The objective of trying to conform tax accounting with business accounting is still a sound one." We submit for your consideration the thought that where business accounting--as in the case of the railroads--must conform to regulations prescribed by public authority there is no occasion for apprehension that the availability of section 462 will result in indiscriminate estimates giving rise to undue advantage to the taxpayer. For example, Mr. Chairman, it is certain that the Commission would not permit the setting up of reserves to cover maintenance costs which has been so frequently referred to in the course of these hearings. On the other hand, with respect to vacation pay accruals, it is possible that the Government might realize a windfall at the expense of the railroads, through depriving them of any deduction for vacation pay in some 1 year, as I shall point out in a little more detail in a moment.

Before discussing any specific items, a general statement needs to be made in the interest of clarity. The accrual basis of accounting requires the deduction of expense items at such time as will clearly reflect income for the current taxable year (sec. 446 of the Internal Revenue Code of 1954). There is now, and always has been, an area of controversy with respect to the proper year for deduction of

many different items of expense which it was the purpose of section 462 to cure. The deduction of such items is inherent in the accrual basis of accounting.

The Uniform System of Accounts for Railroad Companies prescribed by the Interstate Commerce Commission (issue of 1952, at p. 31) provides with respect to unaudited items affecting operating accounts as follows:

> When it is known that a transaction has occurred which affects operating revenues or operating expenses, but the amount involved and its effect upon the accounts cannot be determined with absolute accuracy, the amount thereof shall be estimated and included in the appropriate operating and balance-sheet accounts. Any such estimate shall be revised whenever and at the time a substantial change is indicated and shall be finally adjusted a soon as the exact amount is determined. The carrier is not required to anticipate items which would not appreciably affect the operating accounts.

Under this regulation, for example, two very substantial items of liability which the railroads are not only permitted but required to accrue on their books are their liabilities for personal injuries and freight loss and damage. These liabilities come into existence at the very moment when the person is injured or the property is damaged, but for the first time the Internal Revenue Code gave in section 462 recognition to such liabilities. We think that there is no reason for apprehension that the setting up of such reserves as these by railroad companies will result in any undue advantage to the taxpayer. Contrariwise, the real result is that for the first time the taxpayer is assured by statute the right to deduct for tax purposes what always should have been specifically recognized as deductible. We also submit that insofar as railroad companies are concerned there is no reason to fear that unjustifiable items will be claimed, for the Interstate Commerce Commission certainly would not permit them to be placed on the books.

The bill under consideration would repeal sections 452 and 462 retroactively. In the meantime, railroad companies have made and published their financial statements for 1954 reflecting their tax liability based on the law as it stood at the close of that year. The consequence of retroactive repeal would be that the railroads would be placed in the position of having misstated their financial position. Commitments no doubt have been made by these companies and stockholders have no doubt been led to alter their investments in reliance upon statements accurately made under the law but which would be rendered inaccurate by retroactive repeal of the provisions of the 1954 code in question.

The CHAIRMAN. Have you made any estimate of the amount of money involved, Mr. Preston?

Mr. PRESTON. I do not have a money figure in mind, Senator.

The CHAIRMAN. Is it substantial?

Mr. PRESTON. Well, in relationship to any such estimates as have been offered to this committee, looking to the revenue effect with respect to overall industry, the revenue effect of retention of this section so far as the railroads are concerned, in view of the control of the Commission over their accounts, would be only a fraction of the estimates which you have heard. However, I do not have a firm figure in mind.

Senator MARTIN. Is there any way to secure such figures? You make the statement that "companies and stockholders have no doubt

been led to alter their investments." Now, it would seem to me, to cause stockholders to alter their investments.

Mr. PRESTON. Senator, the point is that as to some railroads, some given railroads, the sum is substantial, and might induce stockholders to change their position. But overall in the railroad industry it is my certain belief that the revenue loss is not of any great dimension.

Senator MARTIN. Thank you very much.

Mr. PRESTON. If it be concluded that section 462 will have an immediate revenue effect which requires that it be repealed or modified, we urge that it be modified rather than repealed, and the modification we urge is that the section be retained in respect of the railroads, whose accounting methods and practices are prescribed and supervised by duly constituted public authority.

Retention of the section in this restricted form would certainly not permit any such wholesale reduction of taxable income as we understand to be the basis for the proposed repeal of these two sections of the Internal Revenue Code. If this apprehension persists, however, we suggest that provision could readily be made to spread over a suitable number of years the revenue loss which might occur in the year of transition. And we do not attempt to suggest what that appropriate period of time might be, Mr. Chairman.

If any further limitation upon the application of the section should be deemed necessary, such an objective could readily be accomplished by restricting the reserves to the specific items set forth in your committee's report on H. R. 8300 (Rept. No. 1622, 83d Cong., 2d sess., at p. 306).

In this connection, of primary importance to the railroad industry—and I would like to emphasize particularly the point I am coming to now—is the matter of deduction for tax purposes of accruals for vacation pay. We think it of the utmost importance that the committee clearly understand the situation with regard to this matter. Accruals of reserves for vacation pay to which employees are entitled by reason of service in a current year, but which will not become actually payable until the succeeding year, have been regularly permitted and made by the railroads. Such accrual was expressly authorized by a ruling of the Bureau of Internal Revenue known as I. T. 3956, from which Senator Smathers read a portion this morning, effective for 1941 and subsequent years. This ruling has been revoked with respect to taxable years ending on or after June 30, 1955, and in that connection we call attention to the statement of Mr. Robert A. Kagen, member, legal advisory staff, Department of the Treasury, in the course of the hearings before the Ways and Means Committee on March 11, 1955, at page 75 of the transcript, to the effect that the Revenue Service repealed that ruling on the belief that taxpayers who previously acted under the 1947 ruling (I. T. 3956) would continue to take vacation pay under section 462.

With respect to vacation pay, therefore, the situation is that accruals have regularly been made and recognized pursuant to a ruling of the Bureau of Internal Revenue which the Internal Revenue Service has now revoked on the belief that taxpayers who had previously relied upon the ruling would continue the accrual of vacation pay under section 462. There is no question here of any double deduction resulting from taking the tax benefit of actual payments in a given year and the accrual in the same year of prospective payments.

The question is whether the railroads might be deprived of any deduction whatever in 1 year on account of vacation pay. Far from a windfall to the taxpayer, this would result in a windfall to the Treasury at the unjust expense of railroad taxpayers. We are confident that the administrative authorities could prevent this, for we believe that our present vacation pay agreements fully qualify for the accrual of the item under the regular provisions of law, and we would hope they would do so. If, however, section 462 is repealed and administrative relief with respect to vacation pay is not forthcoming under present law, then we think that legislative relief will be required to prevent a rank injustice to the railroads.

We have not overlooked the assurance given by Secretary Humphrey to the Ways and Means Committee, and repeated before your committee yesterday, Mr. Chairman, that revenue ruling 54–608, which would effect the revocation of I. T. 3956, will be permitted to take effect only with respect to taxable years ending after December 31, 1955.

I must say, Mr. Chairman, that I fail to derive much comfort from the assurance of the Secretary that the status quo will be maintained through 1955, for that seems to indicate that the Secretary fails to realize that that would merely postpone the wrongful results from 1955 to 1956, which results in the fact that there would be a loss of any deduction for vacation pay in 1956.

Mr. Chairman, in the course of his testimony yesterday, Mr. Seidman indicated that your committee has under consideration what he referred to as a staff substitute for outright repeal of 4725. In that connection I should like only to say that it would certainly be our hope that if any such measure is to be approved by your committee it at least have the breadth to cover this matter of vacation pay, and also the matter of liabilities for self-insured personal injuries and property damage claims. These three items have been listed by your committee as within the original intendment of section 462 at the time you reported H. R. 8300.

That is all I have, Mr. Chairman, and I thank you very much for the opportunity to appear.

The CHAIRMAN. Thank you very much.

Any questions?

(No response.)

The CHAIRMAN. The next witness is Mr. E. M. Fuller, chairman of the American Cotton Manufacturers' tax committee.

STATEMENT OF EDWARD M. FULLER, SECRETARY AND TREASURER OF GREENWOOD MILLS, INC., OF NEW YORK CITY, ON BEHALF OF AMERICAN COTTON MANUFACTURERS INSTITUTE, INC.

Mr. FULLER. My name is Edward M. Fuller. I am secretary and treasurer of Greenwood Mills, Inc., of New York City, and I appear here on behalf of the American Cotton Manufacturers Institute, Inc., whose headquarters are in Charlotte, N. C. The institute's membership comprises manufacturers of more than 80 percent of the cotton broad woven goods produced in this country, and I might add, a very substantial proportion of the goods woven from manmade fibers or goods and a very substantial proportion of the woolen fibers manu-

factured in the Nation. The purpose of my appearance is to oppose the repeal of sections 452 and 462 of the Internal Revenue Code of 1954.

Everybody recognizes that for many years past corporate taxpayers on the accrual basis have been paying taxes on fictitious income. They have been reporting taxable income which they knew full well would be reduced, and in many cases had been reduced, on their books because of existing or contingent liabilities for expenses of vacation pay, returns and allowances and similar clearly foreseeable expenses. At long last there has been written into the tax law provisions which correct admitted inequities which have prevailed longer than they should. To the industry I represent, retroactive repeal at this late date would only compound inequities and throw corporate financing and accounting into a turmoil. It would, indeed, be a tragic step backward.

We are, of course, aware of the attendant loss of revenue for the transitional year. However, surveys have indicated that this loss will be very much less than that predicted only a few weeks ago. Furthermore, from the testimony already furnished this committee, it is abundantly clear that the impact on the revenues in the transitional year can be minimized by a stretch-out of the deductibility of the initial reserve. We recommended a 3-year stretch-out before the committee on Ways and Means of the House. We would accept any stretch-out, even up to 10 years, if it would preserve the basic principles of these sections in the law.

We are aware, too, of the one-time threatened abuse of section 462. We concede that as it now stands section 462 is perhaps too broad providing that the scope of the election made under the section "shall apply to all estimated expenses attributable to the trade or business." Admittedly, this opened the door to speculation as to whether a deduction would be lost entirely if not reserved as an estimated expense and caused some corporations to believe that they were entitled to and, in fact, were required to set up estimated expenses for items not closely related to the income of the tax year. Expenses of repair and maintenance, stated by the Secretary of the Treasury before this committee to be the biggest worry to the Treasury Department, are an example.

Accordingly, we are in thorough accord that section 462 should be amended to provide for specific items which concededly are properly accruable and directly related to the tax income for the year of the election. We suggest that such items include vacation pay, sales returns and allowances and related repayment of commissions, freight allowances, product warranties and guaranties—but only for a limited period of time, perhaps 5 years, cash and quantity discounts, and discounts for anticipations.

My association's tax committee and the association's membership submit to you that if the items of expense are limited on a realistic basis and if the deduction for the initial reserve in the year of election is stretched out over a period of years as proposed the net loss of revenue will not be more than $30 million a year over a 10-year period. We state most sincerely that this is a small price to pay for the long overdue correction of the inequities of the past arising out of the failure of tax accounting to recognize sound business accounting principles.

We know that this committee has already heard much of the hardship and confusion which would follow retroactive repeal of these sec-

tions. We produced before the Committee on Ways and Means numerous examples of this in our industry and read into the record there telegrams from mills in eight States stretching from Maine to Alabama. Let me read only one of those: From Danville, Va., Mr. W. J. Erwin, president and treasurer of Dan River Mills, wired this to me:

We urge you as chairman of the ACMI tax committee to protest * * * the proposed retroactive repeal of section 462 of the 1954 Revenue Code, part of Public Law enacted August 16, 1954. Your immediate action is requested for the following reasons:

1. Our annual report to our stockholders for the year 1954 has been published and distributed based upon our election to avail ourselves of the provisions of section 462 of the 1954 code as it now stands.

2. We have formulated and entered upon plans for machinery and equipment, modernization for the retirement of preferred stock, and compliance with requirements of our long-term debt agreement, based upon cash forecasts which took into account the provisions of section 462.

Apart from the substantial increase in our 1954 tax liability should section 462 be retroactively repealed our company will have quite serious problems of adjustment to this wholly unexpected change in the rules.

3. We in company with all other accrual-basis corporations, made the election of section 462 in good faith. Should the section be repealed the confidence of business in general in the administration of the Federal tax laws will be seriously undermined to the detriment of all.

There is an example of how retroactive repeal of this section would cut across commitments already made. So would repeal embarrass and confuse corporations subject to the Securities and Exchange Commission regulations. It is now too late to make any revisions in this material by corporations who report on the basis of a 1954 tax.

May I submit another illustration of undue hardship and downright inequity. This is an actual case. One of the great mill organizations among our membership established and deducted in a prior year (I believe it was 1943) a reserve for vacation pay. This was not a mill with a union contract. The Internal Revenue Bureau disallowed the item and the company paid the deficiency. Proceedings to recover the payment were pending at the time section 462 became law. Thereupon, the Internal Revenue Bureau approached counsel for this taxpayer and pointed out that section 462 "has now taken care of your situation" which, in fact, it had, and the Bureau persuaded the taxpayer to abandon its efforts to recover the deficiency and to sign a waiver, which it did. If section 462 is now repealed, this case will be a striking illustration of the unfairness of changing the score and the rules after the game has been played.

We understand that, at the request of this committee, there has been presented to it by the staff of the Joint Committee on Internal Revenue Taxation a proposal for amendment of the statute in lieu of outright retroactive repeal. If our understanding of this proposal is correct, it limits the items deductible under section 462 to product warranties or guaranties and service contracts, cash and quantity discounts, vacation pay, freight allowances, and repayment of commissions. We believe, as I indicated before, that the item of sales returns and allowances is properly accruable, fairly ascertainable, and should also be included. Thus restricted, we believe that section 462 would be realistic and workable without resulting in any undue revenue loss.

We understand further, however, that the effect of this proposal—I mean the staff proposal—would be to disallow completely the tax deductibility of the reserve to be set up in the year of election. When

the Revenue Code of 1954 was first considered, it was recognized that there would be some revenue loss in the year of transition. It was recognized that there would be a price to pay in order to rectify the wrongs in the past and put all taxpayers on an even footing. We see no reason why that concept should be changed, and we urge that the impact on the revenue be minimized by a stretchout of the transitional bulge rather than by what amounts to the disallowance of a deduction for expenses actually incurred.

In conclusion, therefore, it is the request of the American Cotton Manufacturers Institute that sections 452 and 462 be retained in the law with safeguards providing specifically the types of reserves allowable, and we have referred to those that we suggest, and to provide that the deductibility for tax purposes of the reserves be spread or stretched out over such period of years as to this committee seems necessary and advisable.

Mr. Chairman, we thank you very much for holding these hearings. In looking over the list of witnesses to appear we don't see anyone from the office of Mr. T. Coleman Andrews, Director of the Department of Internal Revenue. We have heard rumors that Mr. Andrews and his associates feel that sections 452 and 462 might well be and in fact should be retained in the law and that the stretchout as proposed almost unanimously by industry would be the answer to the question. I respectfully suggest, sir, that perhaps you would like to hear Mr. Andrews, or at least have a communication from him, because, as you recall, the Secretary of the Treasury seemed to feel that there were great administrative problems involved, and that such a stretchout proposal couldn't work for that reason.

Another thing I would like to say is that we understand the Department of Commerce likewise favors the position which industry is taking here on this issue.

Mr. Chairman, we thank you for the privilege of appearing before your committee.

The CHAIRMAN. Thank you very much, Mr. Fuller.

Any questions?

(No response.)

The CHAIRMAN. The next witness is Mr. Robert A. Seidel, Radio Corporation of America.

STATEMENT OF ROBERT A. SEIDEL, EXECUTIVE VICE PRESIDENT, RADIO CORPORATION OF AMERICA

Mr. SEIDEL. My name is Robert A. Seidel. I am executive vice president of the Radio Corporation of America in charge of consumer products and also a director of the RCA Service Co., Inc., which is a wholly owned subsidiary. We are grateful to this committee for holding public hearings on this repeal bill so that this most important measure may be fully understood and frankly discussed.

I am here to speak only in support of section 452, even though RCA and its subsidiaries have a larger financial stake in section 462. We recognize that section 462 involves a great deal of revenue because it affects practically every corporate taxpayer. We also recognize that section 462 in its present form may be susceptible of abuse. Section 452, on the other hand, corrects hardship for a rather small number of businesses which now suffer severe discrimination; it does not involve any substantial amount of revenue; and it is not susceptible of abuse.

Let me first describe the role of prepaid moneys and fees in the TV service industry.

The people who purchase TV sets want to be sure that their sets are kept in good working order. So many of them buy TV service contracts, which generally run for a term of either 1 or 2 years. The RCA Service Co. sells such contracts, as do a large number of other service companies. The great majority of such other companies would be classified in the small-business category.

Service contracts are usually sold at the same time the sets are sold. Typically, therefore, payment for a TV service contract will be received at the time the set is sold, but the service company's cost of fulfilling that contract will be incurred during the following year or 2-year period. Such a contract may sell for $50 today to cover the service company's liability for the ensuing 12 or 24 months. On such a transaction, we, and all other service companies have been required by the Treasury to report the $50 receipt as if it were an immediate profit and to pay a tax of roughly $25 on it. Obviously, this is an unfair and unrealistic method of taxation. Incidentally, further to aggravate this situation, television sales are seasonal, and a substantially greater portion of the receipts for the sales of television service contracts occur in the fall of the year.

In 1948, when the television business began to grow and the RCA Service Co. was confronted with this problem of having to pay an income tax on what clearly was not income, we went to the Bureau of Internal Revenue and asked for a ruling similar to a ruling which magazine publishers obtained in 1940. This ruling allowed the publishers to report income from prepaid magazine and newspaper subscriptions over the period covered by the subscriptions. We quite naturally assumed that what was right for the publishers would be right for us. We pointed out that, like the publishers, we, in calculating our income, accrued income from TV service contracts only as earned. We stressed that this was the basis of our reports to stockholders and to the SEC.

As a matter of fact, we couldn't sleep at night were we to include customers' prepayments for service as income on our books. It would be the grossest misrepresentation, and certainly no public accounting firm could, with a clear conscience, certify a report to shareholders or to the SEC which classified such funds as income.

During our discussions with the Treasury Department no one was able to distinguish our case from that of the publishers. And no one denied that in principle we were entitled to the same treatment as the publishers. However, we were told we couldn't get the same treatment as the publishers because the publishers had for many years prior to 1940 been reporting income for tax purposes only as earned, whereas we had never done so. In other words, we were denied the fair and equitable tax treatment given the publishers because the TV service industry was a new industry.

The TV service industry labored under this discrimination until Congress took note of the unfair tax treatment that the industry and certain other industries were receiving, and incorporated section 452 into the 1954 Internal Revenue Code. That the Senate clearly wanted to relieve the plight of the TV service industry is shown by the fact that prepaid income from TV service contracts is cited in this committee's report on the revenue bill of 1954 as a prime example of what section 452 was designed to cover.

Section 452 put other taxpayers having prepaid income on the same equitable footing with the publishers, and was hailed as a long-overdue correction of inequity. In general, the TV service companies have elected, or have planned to elect, under section 452, and have made their capital commitments for 1955 on the basis of tax relief under section 452. The proposed repeal of section 452 is a serious blow to them and could conceivably put some of the smaller service organizations out of business. The industry therefore appeals to this committee to save section 452. However, we appeal even more strongly to the committee to consider two developments that would perpetuate and aggravate the discrimination against us.

The first is this: When the repeal bill was introduced, it became apparent to the publishing industry, which had been permitted to report income realistically under the administrative practice sanctioned by the Treasury Department, that repeal of section 452 would constitute Congressional repudiation of the administrative practice. This would cause the publishers to be taxed the same as the TV service companies have been taxed. However, at this juncture the Secretary of the Treasury wrote a letter, dated March 22, 1955, to the Chairman of the House Ways and Means Committee, stating that—

> the Treasury Department will not consider the repeal of Section 452 as any indication of Congressional intent as to the proper treatment of prepaid subscriptions and other items of prepaid income.

We fully agree with the Secretary's ruling, and note that he made it notwithstanding the fact that upwards of $50 million of tax revenue was involved in the case of 12 magazine publishers. We must be absolutely certain that our industry is accorded the same equitable treatment.

Very soon after the Secretary's letter, the press reported a recommendation from the staff of the Joint Committee that Section 452 be rewritten to permit the realistic treatment of only three specifically enumerated types of prepaid items, namely, newspaper and periodical subscriptions, rents, and service association dues and fees. The last category, we are advised, covers dues and fees paid to such organizations as automobile clubs, but not those paid to television service organizations.

The net effect of this proposal is to extend for the first time to all publishers, to landlords, and to the automobile clubs, the same realistic treatment heretofore received by a group of the more important publishers, thus magnifying the discrimination against the TV service men.

Coupled with this proposal we understand there is a proposal to cover TV service contracts in a greatly watered-down version of section 462, which would involve no tax relief for 1954. It is my best guess—just as a businessman who tries to follow legislative developments—that section 462 will not survive in any form, but will be repealed.

If relief under section 462 is proper, why not take care of the publishers, the landlords, and the automobile clubs under section 462? Section 462 would be just as appropriate for them as for us.

All such proposals are unpalatable to our industry. Their effect is to extend realistic treatment to three additional groups but to continue the discrimination against us under which we have chafed for many

years. We trust that this committee will not place its stamp of approval on anything so unreasonable and unjust.

Time would not permit my answering the reasons that have been advanced for the repeal of section 452. However, I have a memorandum demonstrating that the reasons advanced are not valid and I ask the committee's permission to have the memorandum incorporated as an appendix to my statement.

The CHAIRMAN. Without objection it may be incorporated.

(The memorandum referred to is as follows:)

APPENDIX—REPLY TO THE TWO ARGUMENTS THAT HAVE BEEN ADVANCED FOR REPEAL OF SECTION 452

SUMMARY

The sole ground cited in the report of the House Ways and Means Committee for coupling repeal of section 452 with repeal of section 462 is the fear that taxpayers might obtain the 1954 tax reductions they expected under section 462 "by changing the form of the transaction" and qualifying for section 452 relief. This fear is wholly unwarranted.

It is now too late for taxpayers to change the form of any 1954 transactions in order to have prepaid income which would entitle them to make a section 452 election without the Secretary's consent.

And section 452 itself contains the provision that elections to report post-1954 prepaid income under section 452 can be made only with the consent of the Secretary. If the Secretary believes that a taxpayer has changed the form of a transaction so as to obtain section 462 relief under section 452, he has only to withhold consent to the taxpayer's election of section 452 coverage.

On the floor of the House, Representative Jere Cooper gave as a reason for repealing section 452 that, if it were not repealed, many taxpayers would elect to defer reporting of prepaid income but would take current deductions for commissions and other related expenses. The answer to this is to add a sentence to section 452 requiring deferment of the related expense deductions if an election is made to defer reporting prepaid income.

DISCUSSION

(1)

In its report on H. R. 4725, the House Ways and Means Committee has recommended retroactive repeal of sections 452 and 462 of the 1954 code, relating to prepaid income and reserves for estimated expenses, respectively.

The sole ground advanced by the committee for recommending repeal of section 452 is that it could be availed of to do the work of section 462 and thus bring about some of the same losses of revenue that section 462 would occasion. The report states at page 4:

"Proposals have been advanced that the income-deferring provisions of section 452 should be retained in the law even though the estimated expense provisions of section 462 are repealed. It is contended that the revenue loss from section 452 is relatively insignificant in relation to the loss involved in section 462. Your committee has given careful consideration to the possibility of such action. It has been advised by the Treasury, however, that if section 452 is not repealed at the same time section 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of section 462 would be able to accomplish the same result by electing to defer income under section 452. For example, under section 462 it is possible to set up a reserve for estimated expenses attributable to fulfilling obligations of servicing and repairs under a product guaranty. If section 462 only were repealed, it would be possible for taxpayers, simply by changing the form of the transaction, to defer under section 452 that portion of income from the sale of the product which is attributable to the liability for future servicing and repairs under the guaranty. It is, therefore, deemed necessary to repeal section 452 as well as section 462."

It is doubtful whether it would be commercially feasible for many taxpayers to change the form of their transactions so as to defer under section 452 income which they would have been able to offset by reserves for estimated expenses under section 462. But even if the envisaged creations of prepaid income in

businesses where none existed before were a practical possibility, there would be no substance to the Treasury's argument that it is necessary to repeal section 452 as well as section 462 lest "by changing the form of the transaction" taxpayers might achieve under section 452 what they are to be denied by the repeal of section 462.

What the Treasury has overlooked is the fact that as far as 1954 transactions are concerned it is no longer possible for taxpayers to "change the form of the transaction."

And 1954 is the crucial year. Section 452 permits taxpayers to elect to defer payment of tax on prepaid income without the consent of the Secretary or his delegate only for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954.[1] Once that first year is past the consent of the Secretary must be obtained and the usual revenue-saving conditions to the approval of a change in accounting method can be imposed.

The question might be asked whether a taxpayer who in 1954 had no prepaid income might not, nevertheless, by making a "dry" election under 452 for 1954 and changing the form of the transaction currently, pervert section 452 in the manner indicated and get the benefits without the consent of the Commissioner in 1955. The answer clearly is no because, under the express terms of 452, a valid election can be made only if the taxpayer actually has prepaid income in the year of election.

In short, it is too late for taxpayers to change the form of their 1954 transactions in order to get section 452 benefits; and if they change the form of their 1955 transactions the Treasury has full power under section 452 (d) (3) (B) of the code to protect the revenue by withholding its consent to the election of section 452 benefits.

(2)

In the course of the House debate on H. R. 4725, Representative Jere Cooper referred to a Treasury argument for the repeal of 452 that was not mentioned in the report of the House Ways and Means Committee. He stated (101 Congressional Record, 3115-3116):

"Moreover, the Treasury pointed out that under section 452 while a large portion of the income could be deferred the full expense could still be deducted in the year in which all the income was received. For example, assume corporation X, a real-estate company in the rental business, rented on January 1, 1954, a house for $200 a year for a period of 5 years, all of the rent to be paid in advance. Under the contract the company received $1,000 in rent during the calendar year 1954. Under section 452 this rent could be spread over a period of 5 years and, therefore, the company would only have to report $200 rent for each of the 5 years commencing with 1954. If the commissions and expenses of negotiating the lease amounted to $200, all of this expense could be applied under this section against the $200 rent reported in 1954 and thus eliminate the rental income for that year. This result might have a serious effect upon the revenue. Accordingly, the committee believed it important to repeal section 452 as well as section 462 and instructed the Treasury and joint committee staffs to make a study of this section with the possibility of bringing in corrective suggestions."

At least insofar as the example cited is concerned, the Treasury is in error; under existing law it is well established that the commissions and expenses of negotiating the lease could not be deducted in full in the year the lease is signed. They would have to be deducted ratably over the 5 years. *Gould-Mersereau* (21 B. T. A. 1316); *I. T. 2263* (V-1 Cum. Bull. 66).

However, even the result described by Representative Cooper is apparently one considered acceptable to the Commissioner. His regulations covering the sale of personal property on the installment basis expressly provide that, although the gross profit is deferred, deductible items, including commissions and other selling expenses, are to be deducted in the year paid or incurred, or paid or accrued (Regulation 118, sec. 39.44-1 (a)). If it is nevertheless desired to defer deduction of these items as well, however, it would be simple to amend section 452 (d) (1) by adding a sentence requiring deferment of commissions and other directly related selling expenses. It is to be emphasized that adding such a

[1] Section 1.452-7 (c) (1) of the proposed regulations goes beyond the statute and gives calendar year taxpayers not electing under section 452 for 1954 an opportunity to elect under 452 for 1955 without the Commissioner's consent (provided they file notice of such election prior to June 30, 1955). This would open the door to the abuse of section 452 which the Treasury cited as its reason for requesting 452's repeal. To avoid this result the Treasury has only to delete the proposed regulation—which would be of doubtful validity anyway because at variance with the statute.

sentence would not involve importing section 462-type relief for certain taxpayers into section 452 and thus cost the Government additional revenue. To the contrary, it would cut down the benefit to taxpayers from section 452 and would reduce whatever relatively small cost there would be to the revenue as a result of keeping section 452 on the statute books.

Mr. SEIDEL. May I say in closing that our position in this matter seems crystal-clear. The Treasury's position in holding that advance payments of customers for services to be performed subsequently is taxable income seem untenable. We feel very strongly on this matter. We have been subjected to unfair treatment in constantly increasing amounts for over 9 years. Unless the committee does recognize the clear-cut case of equity involved, we may have no alternative but to incur the expense necessary to contest the legality of this discrimination in the Tax Court. Such action, we believe, would be in the public interest. Gentlemen, we, and hundreds of smaller service companies, have been hurt. And that is contrary to the testimony of Secretary Humphrey that no one would be hurt.

The CHAIRMAN. Any questions?

(No response.)

The CHAIRMAN. We thank you for your testimony, sir.

Mr. SEIDEL. Thank you.

The CHAIRMAN. The next witness is Mr. Fleming Bomar, of American Automobile Association.

STATEMENT OF FLEMING BOMAR, ATTORNEY FOR AMERICAN AUTOMOBILE ASSOCIATION AND ITS AFFILIATED CLUBS

Mr. BOMAR. My name is Fleming Bomar. I am a partner in the Washington, D. C., law firm of Ivins, Phillips & Barker. I appear here in behalf of the American Automobile Association and a substantial number of its affiliated clubs, a list of which will be filed at the end of my statement. The association together with its affiliated clubs, located in every State in the Nation have more than 4½ million members.

The bill before you proposes to kill retroactively two provisions of the 1954 Internal Revenue Code which all agree are desirable in principle. One of those provisions, section 452, is of crucial importance to all automobile clubs and we urge its retention in the law, amended to conform with every suggestion made to you by the staff of the joint committee, which I will refer to as the staff plan. I will discuss the provisions of the staff plan a bit later, limiting my remarks to section 452.

I would like to add at this point, that section 452 has been indicted solely by means of guilt by association. All of the hullabaloo raised has been over section 462. I would like to defend here and defend exclusively section 452. I assumed the television people were going to be taken care of in 462, and therefore there is little reference to them in this statement.

First, a brief background regarding the particular problems of automobile clubs. Prior to 1943, automobile clubs were exempt from all Federal income taxes. Since 1943, the Commissioner and the courts have held that the American Automobile Association and its affiliated clubs are subject to full corporate income, surtax, and excess profits taxes, despite the fact that they are organized as nonprofit organiza-

tions without stock of any kind, and despite the fact that a very substantial part of their time and energy is devoted to activities which are beneficial to the public in general.

An automobile club is in the rather unique position of being a taxable corporation which receives substantially all of its income in the form of dues paid in advance for services to be performed in the future. Since the action which you are considering affects substantially all of the income the clubs receive, you will appreciate their vital concern over your decision.

Let me illustrate the accounting problem involved. Let us assume that a club files its tax return on a calendar year basis and that its only source of income is annual dues of $12 per member. For purposes of simplicity, let us assume that a club has only 1 member who joins on December 1, 1954, and pays $12 dues in advance for services to be rendered through November 30, 1955. Let us assume the club will incur, normally, expenses of 95 cents per month or $11.40 per year, in connection with this 1 membership. The club should wind up with a 60-cent profit and pay a tax thereon.

The accounting profession agrees, and common sense requires, that the proper method of keeping the books and records of the club is to count $1 of the annual dues as income in each month of the membership. In this manner, the income of the club is computed to be 5 cents per month. If section 452 is repealed, however, the club in 1954 must report $12 of income and only 95 cents of expense, and pay a tax on a fictitious profit of $11.05 when its true profit in 1954 was 5 cents. Needless to say, after paying its Federal income tax at present rates, the club does not retain, after taxes, the $11.40 required to provide the services to which the member is entitled.

From the point of view of sound accounting it is obvious that the net income of a club cannot be reflected accurately or realistically unless dues are reported as income over the same period of time that services must be rendered.

A number of automobile clubs have been using this method of accounting for many, many years, even prior to the time when they were first subjected to Federal taxes. The accounting methods of some of these clubs have never been questioned. Other clubs have been compelled to change their methods of accounting to report all dues as income when received. Two clubs are at present litigating their right to report dues as income on an earned basis rather than a received basis. One club, the books and records of which have been audited by different revenue agents from year to year, has already been required to change its method of reporting dues income for tax purposes on five different occasions, and if H. R. 4725 is adopted, that will constitute the sixth change.

The retroactive repeal of section 452 will result necessarily in rank discrimination, further litigation and utter confusion insofar as automobile clubs are concerned. Unlike newspaper and magazine publishers, automobile clubs have not been the beneficiaries of any special ruling from the Commissioner of Internal Revenue approving sound methods of accounting if used historically, although their case is equally meritorious.

The Secretary of the Treasury has asked you to repeal section 452 and section 462 for two primary reasons. One of his reasons is that 1954 revenues will be reduced more than was anticipated, the other

is that these provisions are too broad, would be difficult to administer, and would cause a lot of controversy and lawsuits.

With all deference, we wish to explain that these objections, even if valid, do not apply to section 452, particularly if amended to conform with the staff plan. The revenue reductions under section 452 are extremely small when compared to section 462. The problem of double deductions or concentration of deductions in 1 year is not involved in section 452. And in lieu of causing litigation, the retention of section 452 in the form suggested in the staff plan would settle for future years much existing litigation. It should also be understood that when the Secretary refers to administrative difficulties caused by estimated reserves, he refers to section 462; for section 452 is concerned only with the proper year for reporting known amounts of income received in advance and no estimates whatsoever are involved.

In short, substantially all of the criticism of these provisions has been directed exclusively to section 462, and not section 452. While these two sections may be cousins, they are not Siamese twins and it would be entirely possible at this time to retain one in the law without the other; if you kill one it does not follow that the other should die automatically.

The legislative history of section 452 and the proposed regulations promulgated by the Commissioner make it absolutely clear that this section was intended to cover primarily advance rents, prepaid subscription income, and club dues. Reference in the committee reports is also made to warehouse fees, ticket sales, car tokens, and television service contracts.

Under the staff plan, which I will discuss briefly, the scope of section 452 would be limited by statute to (1) prepared rental income, (2) prepaid newspaper and magazine subscriptions, and (3) service association dues and fees. By enumerating the types of income to which this section applies, it is divorced irrevocably from section 462 and there is no possibility that a taxpayer can switch from one section to the other as was feared by the Ways and Means Committee.

If other types of prepaid income are found in future years to qualify for section 452 treatment, and I must say the preceding speaker have such a case, the statute could be broadened to cover them.

The staff plan in addition to restricting the scope of section 452 adds several necessary safeguards:

First, a requirement would be written into the statute that the books and records of the taxpayer must be kept on a basis reflecting the deferral of prepaid income before the tax returns could be filed on such basis. This provision would limit further the scope of this section, and has our approval.

Second, a provision would be written into the statute requiring that expenses directly attributable to prepaid income be deferred and deducted over the same period of time that the prepaid income is reported for tax purposes. This suggestion conforms with sound accounting practices, and we also approve it.

And finally, the staff plan recommends, and we wholeheartedly approve, a statutory provision to the effect that there is no congressional intent to disturb prior accounting practices which have been approved by the Commissioner for tax purposes. Without such a provision the repeal or the limitation of the scope of section 452 will be used as a sword in the future rather than a shield.

The principles of accounting approved by section 452 should have been authorized by statute many years ago. Without such provisions, certain types of gross income have been taxed improperly before earned. The only problem which arises from the retention of this section relates to the scope of its application. We urge the committee to solve that problem by restricting the scope of the section to the clear cases which the Congress intended to cover originally. Certainly, prepaid rents, prepaid newspaper and magazine subscriptions and prepaid club dues constitute clear cases, which require no further study, and should be covered now. We therefore urge your wholehearted approval of the staff plan for retaining section 452. If your approval is granted, some income which would have been taxed in 1954 under prior law will not be taxed until 1955 or future years, but the amount be small and within original budget estimates, I am advised.

Surely this is a small price to pay for the correction of an obvious, long-standing inequity.

The CHAIRMAN. Mr. Bomar, at the bottom of page 5 you say, "And finally, the staff plan recommends and we wholeheartedly approve, a statutory provision to the effect that there is no congressional intent to disturb prior accounting practices," and so forth. You think that is not covered in this repeal legislation?

Mr. BOMAR. I don't think it is covered adequately.

The CHAIRMAN. Any questions?

Senator BENNETT. I would just like to make one comment. I can understand your testimony that you are perfectly willing to scuttle 462, and then on the bottom of page 5 you say that a provision should be written into the statute requiring that expenses directly attributable to prepaid income be paid and deducted. You seem to be saying that you want the benefit of 462 for your particular type of industry, but you are willing to see it go down the drain for all the others.

Mr. BOMAR. We, as a matter of fact, approve the retention of 462 in the law and would like to see it retained exactly as Mr. Seidman wants it. Insofar as this expense item is concerned, that has the opposite effect. We are not getting an advantage there but are getting hurt. If you collect prepaid income, for example, and pay a commission immediately in connection with it, that provision would require that you spread the deductability of the commission over the same time as you report the prepaid income, and you could not deduct it when you paid it. So it has the opposite effect.

Senator BENNETT. It seems to me that these two principles rise and fall together. If you are going to spread prepaid income you ought to spread on the same principle prepaid expenses. Now, do I understand you to say that you prefer to deduct your expenses when they occur but you want to spread your income forward?

Mr. BOMAR. No, if the expenses are connected with the prepaid income they should, no matter when paid, be deductible only over the same period of time that the income must be spread.

Senator BENNETT. I agree that that is sound. But that also goes over into the basic principle that we should treat the expense side of the thing on the same basis as we treat the income side.

Mr. BOMAR. That is true.

Senator BENNETT. I have listened to your testimony very carefully, and I was impressed by the testimony you gave in which you were anxious to impress the committee that these were not Siamese

twins but that you could hold on to 452 and scuttle 462, and I got from that testimony the impression that you are anxious to see—if you couldn't have them both you wanted 452.

Mr. BOMAR. That is correct.

Senator BENNETT. So in effect you are taking care of your own situation but you are not standing up for the principle which I think is involved here on both sides of the fence.

Mr. BOMAR. I do stand up for the principle, sir. But in the 15 minutes that I had I felt that time permitted me only to defend section 452, in which I am primarily interested.

Senator BENNETT. I am glad to get that straight. You would like the committee to know that you are as eager for the retention of 462 as you are for 452?

Mr. BOMAR. Yes. But I would like to point out that the administrative difficulties of which the Secretary complained cannot apply with equal force or with any force to section 452. You are dealing with known quantities of income received in advance, the sole question is the proper year of paying the tax and including those amounts in taxable income. There are no estimates, no uncertainties.

The CHAIRMAN. Have you made any estimate of the loss under 452 as compared to 462?

Mr. BOMAR. Mr. Seidman estimated yesterday that the losses overall would be around $50 million. That assumed the retention of section 452 as written. If section 452 is restricted as the staff suggests it is my understanding that 85 to 95 percent of the newspapers are already on that basis, and I can't understand how there could be much loss there. I am advised by the real-estate board that the prepayment of rent is a relatively unusual situation, and would involve little or no loss of revenues. Insofar as automobiles are concerned, there are several millions of dollars involved, less than five.

I would estimate that restricted as the staff suggests, the overall losses shouldn't exceed $15 or $20 million, but Mr. Stam should be a much better judge of that than I am.

Senator BENNETT. Thank you very much.

(Mr. Bomar subsequently submitted the list of affiliated clubs of the American Automobile Association:)

AFFILIATED CLUBS OF AMERICAN AUTOMOBILE ASSOCIATION

AAA Motor Club of Harrisburg, Harrisburg, Pa.
Alabama Motorists Association, Birmingham, Ala.
Arizona Automobile Association, Phoenix, Ariz.
Arkansas Automobile Club, Little Rock, Ark.
The Auto Club of Berkshire County, Pittsfield, Mass.
Automobile Club of Central New Jersey, Trenton, N. J.
Auto Club of Hartford, Hartford, Conn.
Automobile Club of Michigan, Detroit, Mich.
Automobile Club of Missouri, St. Louis, Mo.
Automobile Club of New York, New York City
Automobile Club of Philadelphia, Philadelphia, Pa.
Automobile Club of Pittsburgh, Pittsburgh, Pa.
Automobile Club of Rhode Island, Providence, R. I.
Automobile Club of Southern California, Los Angeles, Calif.
Automobile Clut of Southern New Jersey, Camden, N. J.
Automobile Club of Washington, Seattle, Wash.
Beaver County Motor Club, Rochester, Pa.
Bedford County Motor Club, Bedford, Pa.
California State Automobile Association, San Francisco, Calif.
Carolina Motor Club, Charlotte, N. C.

Chicago Motor Club, Chicago, Ill.
Cleveland Automobile Club, Cleveland, Ohio
Crawford County Motor Club, Meadville, Pa.
Dallas Automobile Club, Dallas, Tex.
Georgia Motor Club, Inc., Atlanta, Ga.
Idaho State Automobile Association, Boise, Idaho
Inland Automobile Association, Spokane, Wash.
Lancaster Automobile Club, Lancaster, Pa.
Louisville Automobile Club, Louisville, Ky.
Mercer County Motor Club, Greenville, Pa.
Minnesota State Automobile Association, Minneapolis, Minn.
Montana Automobile Association, Helena, Mont.
Motor Club of Iowa, Davenport, Iowa.
Kellys White Deer Motor Club, New Columbia, Pa.
North Dakota Automobile Club, Fargo, N. Dak.
The Ohio State Automobile Association, Columbus, Ohio
Oregon State Motor Association, Portland, Oreg.
Reading Automobile Club, Reading, Pa.
St. Petersburg Motor Club, St. Petersburg, Fla.
Schuylkill County Motor Club, Pottsville, Pa.
Tampa Motor Club, Tampa, Fla.
Uniontown Motor Club, Uniontown, Pa.
Valley Automobile Club, Trafford, Pa.
Washington County Motor Club, Washington, Pa.
White Rose AAA Motor Club, York, Pa.
Wilkinsburg Auto Club, Wilkinsburg, Pa.

The CHAIRMAN. Any further questions?

(No response.)

The CHAIRMAN. Thank you very much.

The next witness is Mr. Chester M. Edelmann, American Retail Federation.

STATEMENT OF CHESTER M. EDELMANN, TREASURER, H. L. GREEN CO., ON BEHALF OF THE AMERICAN RETAIL FEDERATION

Mr. EDELMANN. My name is Chester M. Edelmann. I am treasurer of the H. L. Green Co., Inc., which operates 141 variety stores (5 cents to $1 stores) in the United States.

I am appearing on behalf of the American Retail Federation which is composed of 64 State and National retail trade associations representing more than 700,000 retail stores in the United States. The latest available data indicate that there are 7.6 million persons employed in 1.8 million retail stores doing an annual volume of $173 billion. Thus the average retail store is small with average gross receipts less than $100,000. The American Retail Federation represents a large part of this important segment of our economy.

Probably the greatest accomplishment in the enactment of the Internal Revenue Code of 1954 has been conforming tax accounting as nearly as possible to sound business accounting. Sections 452 and 462 are the heart of these accounting principles.

It is safe to say that no two sections received as much publicity and discussion by lawyers, accountants, tax executives, and tax services, as did 452 and 462. It is therefore difficult to understand how such reputable newspapers as the New York Times and the New York World-Telegram referred to these provisions as loopholes giving business concerns an unexpected windfall. Even Secretary of the Treasury, George M. Humphrey, was quoted as having told the Committee

on Ways and Means of the House of Representatives that "he knew nothing about it at all."

There has been a lot of loose talk, even by those who really know better, about these sections providing double deductions, windfalls, etc. Nothing could be further from the truth. Neither the 1939 nor the 1954 Code permits a double deduction of the same item. For many years taxpayers and their representatives have rightly complained about being unfairly and unjustly taxed on income not earned, and about not being permitted to deduct all the reasonably known expenses incurred in the production of income. At long last, the Treasury, congressional committees and Congress itself recognized these inequities of the 1939 Code and had the moral courage to correct the injustices of the past by providing a transitional period and a permanent going forward period where tax accounting and recognized business accounting principles would coincide. With respect to section 462, the taxpayer was knowingly permitted to deduct in 1954 the expenses he paid in 1954 attributable to his 1953 operations which had not been allowed as a deduction, and in addition, he was knowingly permitted to deduct a reasonable amount of future expenses to be incurred in connection with his 1954 operations. Thus in the transition year 1954 2 years' deductions were knowingly compressed into 1 year. There was no double deduction, no windfall, no loophole. There was a correction of a gross inequity.

No one has ever questioned the soundness or the desirability of the principles of sections 452 and 462. Experience however now indicates that certain improvements can be made to make their use more effective and less controversial. Outright repeal is not the answer. It is about as sensible as recommending that the way to cure a headache is to cut off the head.

There can be no doubt that as section 462 was enacted it was likely to lead to many abuses. The proposed regulations attempted to cure some of them. Then in February 1955 Representative Herbert Zelenko, of New York City, announced that the loss of revenue to the Government due to the operation of this provision would amount to $5 billion. Other estimates were $1 billion and upward.

Essentially the difficulties with section 462 are administrative and fiscal. Many qualified professional organizations such as the American Institute of Accountants, and Federal Tax Forum, have made suggestions which we think will reduce the problems of administration to a minimum. We endorse the following recommendations:

1. Require the "Reserves for estimated expenses" be set up on our taxpayer's books by a charge to operations.

2. Restrict the items coming within the scope of this section to the ones mentioned in the committee reports.

3. Permit the taxpayer to deduct any or all of the permissible categories.

We think that curing the disease is better than killing the patient.

The fiscal difficulty has been grossly exaggerated. The sampling of the American Institute of Accountants that the revenue effect for the year 1954 is likely to be less than $500 million should be welcome news to the Treasury. Suggestions have already been made to the Committee on Ways and Means that the revenue effect for 1954 be spread over a period varying from 3 to 10 years. We favor a 5-year

period as recommended by the National Association of Manufacturers. This is not a revenue loss. It is merely an acknowledgment that the Treasury has unjustifiably collected this amount in prior years and is now rightly refunding it. There is no more of a loss involved than when the Treasury pays back $500 million it has borrowed from its citizens.

There is a very good reason why the stretchout should be limited to 5 years. Assuming a transitional cost of $500 million, the annual effect on the revenues would be a reduction of $100 million for the next 5 fiscal years. However, this will be more than offset by an additional $150 million which will flow into the Treasury each year for the next 5 fiscal years due to the advance payments required of certain fiscal year corporations. For details see page 139 of Report No. 1622 of the Committee on Finance, United States Senate, dated June 18, 1954.

It is therefore apparent that a 5-year stretchout could be accomplished without any net effect on the revenues. In the interest of economical administration it is suggested small amounts be allowed in full the first year—gradually increasing to a 5-year spread under a scale as follows:

Revenue effect:	*Period of recovery (years)*
Less than $10,000	1
$10,000 to $25,000	2
$25,000 to $50,000	3
$50,000 to $100,000	4
$100,000 and over	5

Mr. Chairman, in view of recent reports in the newspapers it is difficult to see that there is any fiscal problem at all. In the last few days the CED has announced that the 1956 budget could be balanced after providing substantial tax reductions to individuals and corporations. It has also been reported that the President's Business Advisory Committee has informed the President that the likely continuance of the present rate of industrial activity will likewise permit tax reductions in 1956. And only on Monday of this week the New York Times reported that a newly formed Senate—House subcommittee of 3 Democrats and 2 Republicans, with Representative Wilbur B. Mills, of Arkansas, as chairman, will study the most effective methods of tax reduction. Surely these reports do not indicate that the Treasury is justified in asking outright repeal of sections 452 and 462 considering the concessions that the taxpayers themselves are willing to make.

But we are not concerned merely with technical tax matters. There is the greater problem of morals and justice. If Congress expects the taxpayer to be fair with the Treasury, then Congress must be first fair with the taxpayer. Congress has never repealed retroactively any provision of a taxing statute to the detriment of the taxpayer. Many taxpayers have already closed their books, sent their certified statements to stockholders, creditors, and have filed their income-tax returns on the basis of the 1954 code. The retroactive repeal of sections 452 and 462 because of certain administrative and fiscal difficulties, most of which have been exaggerated or which can be readily cured, would establish a dangerous precedent.

It has been reported that the Treasury has about 70 changes to recommend—changes to cure defects in the present code. Yesterday

the Secretary said that a number of these were relatively unimportant. It has not asked that these changes be made retroactive and as a matter of fact no congressional committee has sought action on them. If any of these 70 changes are enacted in 1956 will they be retroactive to 1954? How can you expect taxpayer confidence in a government that changes the rules in its favor after taxpayers acted in good faith in reliance upon those rules?

Mr. Chairman, you are admired for your integrity and fiscal soundness and your zeal for a balanced budget. But there are some things that are even more important than these material aims. Foremost is moral integrity. There is no substitute for it—not even a balanced budget. In 1954 you gentlemen had the moral courage to correct a patent injustice by enacting sections 452 and 462. Do not let political or fiscal expediency swerve you from the sound economic and tax principles that these sections represent. In conclusion, as an active Christian layman, I would like to paraphrase Matthew 16:26—

For what is a man profited if he shall gain the whole world and lose his own soul?

What shall it profit the Treasury to gain $500 million and lose the respect and confidence of the American taxpayer?

Senator BENNETT (presiding). Thank you, Mr. Edelmann. I am sorry that the chairman was not here to hear the paragraph on the bottom of page 5 which was specially addressed to him. And I will ask Mrs. Springer to see that it comes to his attention directly.

Mr. EDELMANN. Thank you.

Senator BENNETT. The chairman had to leave for another appointment. He has directed me to recess these hearings now, and they will be taken up again in this room at half past 2 with Mr. Tye as the first witness. We are now in recess.

(Whereupon, at 12:45 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The CHAIRMAN. Other members of the committee will be present shortly.

The first witness will be Mr. Tye, special tax counsel, National Association of Insurance Agents.

I am sorry there are not more of us here, but at least we will get your views in the record, and we shall be pleased to have them.

Mr. Tye, will you proceed, please?

Mr. TYE. Yes, sir.

STATEMENT OF CHARLES W. TYE, SPECIAL TAX COUNSEL, NEWARK, N. J., ON BEHALF OF NATIONAL ASSOCIATION OF INSURANCE AGENTS, NEW YORK, N. Y.

Mr. TYE. I am Charles W. Tye, attorney and special tax counsel to the National Association of Insurance Agents. My statement is made on behalf of National Association of Insurance Agents, a voluntary membership association numbering in excess of 32,000 insurance agency members. Included in this membership are an estimated 150,000 individuals, duly licensed by the respective States, who are proprietors, partners, or corporate principals in the firms and corporations which comprise said insurance agency members. The agencies

represented by this association are almost entirely in the category of small business. This organization is comprised of independent businessmen who specialize in the production and servicing of policies of fire, casualty, surety, marine and all other lines of general insurance for clients ranging from the smallest householder or automobile owner to the largest industrial corporation.

We sincerely appreciate the opportunity to appear before the Senate Committee on Finance today in order that we may respectfully urge that this committee make every effort to retain the desirable substantive provisions of sections 452 and 462 of the 1954 code. On behalf of the small businessman whom we represent, we are expressing our hope that this committee will see fit to recommend the amendment of sections 452 and 462 rather than outright repeal, in order to preserve the sound tax accounting provisions contained therein and which provisions are especially appropriate to the accounting operations of the average insurance agency. In fact, the financial statement of an insurance agency would more accurately reflect the financial status of the agency under the accounting theory expressed in these two sections.

That insurance agency taxpayers hailed the enactment of sections 452 and 462 is quite understandable since they have been plagued for over 20 years by the Supreme Court decision in the case of *Brown* v. *Helvering* (291 U. S. 193), which, largely based on the "claim of right" doctrine promulgated in *North American Oil Consolidated* v. *Burnet* (286 U. S. 417), denied to insurance agents the tax accounting treatment contemplated by sections 452 and 462.

It is significant that even prior to the Internal Revenue Code of 1954, there was evidence of reluctance on the part of the courts to carry the previous judicial interpretations to the drastic lengths dictated by a continuance of the distortions inherent in the arbitrary application of the "claim of right" doctrine. For example, in a recent case involving an insurance agency, *Leedy-Glover Realty and Insurance Company* v. *Commissioner* (13 T. C. 95, affirmed 184 F. (2d) 833), the decision of *Brown* v. *Helvering, supra*, was distinguished in determining when income had been received for tax purposes, based largely on a showing of services to be rendered by the insurance agency. The court states:

> The facts are, however, that the commissions were not fully earned, because of petitioner's obligation to service the policies over their full terms. * * *

Similarly, in the recent case of *Beacon Publishing Company* v. *Commissioner*, decided on January 3, 1955, by the United States Court of Appeals for the Tenth Circuit, the court did not follow the rationale of *Brown* v. *Helvering, supra*. The question presented in this case was whether sums received for prepaid newspaper subscriptions should have been included in the taxpayer's income for the year in which they were received or prorated over the unexpired subscription period. The court declared that the obvious purpose of sections 41 and 42 of the 1939 Internal Revenue Code was to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently. The court, as a practical matter, repudiated the "claim of right" doctrine as being inapplicable to many types of situations theretofore subjected to the doctrine. Rigid application of the "claim of right" doctrine would, in the court's

opinion, result in a distortion of the taxpayer's taxable income in most cases. The court stated:

> Plainly, section 42 (I. R. C. of 1939) contemplates that prepaid sums can be returned in a year other than when received. It says that income shall be included in the taxable year received "unless under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period." This is not a case where the Commissioner has exercised his broad discretion to require a taxpayer to adopt an accounting method which will clearly reflect income, but is one in which he has improperly applied a legal principle.

We believe that the judicial trend is toward the view that tax provisions of the law should be in harmony with generally accepted accounting principles, which judicial trend obviously had considerable bearing upon the deliberations of the Congress in the enactment of sections 452 and 462. We believe the Congress should repeal statutes which cover accounting principles already sanctioned by the courts only under very compelling circumstances.

Inequities in the former tax laws affecting insurance agencies, such as those which are members of this association, have been outlined in detail in previous presentations to the House Committee on Ways and Means. However, a brief summary of one set of circumstances which led to tax inequities in the prior law is set forth as follows:

The typical insurance agency writes a substantial percentage of insurance policies for its assureds on the so-called term-rule basis. On term-rule business the entire premium is prepaid and the agency receives its entire compensation at the outset of the policies which it has a liability to service for the entire term up to 5 years. A term policy is popular with assureds because a premium saving of up to 20 percent for a 5-year policy can be made. The premium on term policies for a commercial or manufacturing client can be substantial, and in the year of receipt of commissions the insurance agency may be thrown into an abnormally high tax bracket.

By the terms of its contract with the insurance companies which it represents, the insurance agency is required to return a proportionate part of the commission originally received in the event coverage is canceled or reduced during the term of the policy. In all cases where the term rule is involved the insurance agency is subject to a potential distortion of its tax liabilities under the law prior to the enactment of 1954 code. The distortions result in part from the following factors:

(1) Where the insurance agency has received its entire compensation in advance for a term policy of up to 5 years, and expends substantial amounts in servicing the policies for the entire term, the sound accounting objective of relating income and expenses as closely as possible in the same year is unavailable. The result is a "peak and valley" situation which ordinarily results in an abnormally high tax liability.

Senator BYRD. Will you explain what those expenses are for servicing the policy?

Mr. TYE. The expenses for servicing the policy would be in connection with the writing up of daily reports, the handling of lost claims during the period of the policy, the handling of renewals, the changing of coverages as there may be need for additional coverages and things of that type which the American Agency system has uniformly over a period of years handled on behalf of the insurance companies.

The CHAIRMAN. Is a substantial amount involved?

Mr. TYE. It could be substantial, depending upon the volume of term business which the agencies write.

And I might add that more and more our term policies, that is, the 3- and 5-year policies, are being written primarily in view of the installment financing which has now come into the form in the last few years. And in this connection, a part of the expense of an agency would be the financing of that business in that the agency itself is liable for the premium whether or not collected and of necessity has to carry a substantial reserve in order to pay off the insurance companies as these premiums become due, whether or not collected from the insured.

I do not know the exact amount involved; it would vary among agencies.

The CHAIRMAN. You may proceed.

Mr. TYE. (2) The peak and valley situation is distorted further in the event that the coverage is reduced or canceled before the expiration of the policy, with subsequent return commissions by the agency. In this situation, it has been placed in an abnormally high tax bracket in the year when compensation was received; it has made substantial expenditures in servicing the policy prior to cancellation; and it has repaid substantial sums in the lower tax-bracket year of cancellation.

The problem of the potential loss of revenue in 1954 is one which, of course, is of paramount consideration to this committee. However, we believe this is not so much a question of "windfalls", as that term is generally understood, but one of transition since we do not believe a real double deduction under section 462 is involved. Also, under section 452, all prepaid income will be taxed; the only problem is time. In the case of prepaid term commissions this will occur in 3 to 5 years.

We are agreeable to appropriate amendments which would reduce the immediate loss of revenue due to this transition problem, and we also are in accord with views heretofore expressed before this committee that it would be advisable to specify the items which would qualify under sections 452 and 462. In this regard, we believe that prepaid term commissions, which contemplate service by the insurance agency over the period of the insurance policy, should be listed as qualifying for deferral under section 452—in this regard, I see no difference between prepaid term commissions and newspaper subscriptions and other items now listed in the joint committee's approach to this amendment—and also the liability for return commissions in the event of cancellation prior to expiration should qualify for reserve treatment under section 462.

However, the agency would have to elect which section it chose to come under, and once having made such election could not change without the prior written consent of the Secretary or his delegate.

For these reasons, we very respectfully urge this committee to carefully consider suitable amendments to sections 452 and 462 to preserve the sound and equitable tax accounting provisions for taxpayers such as the large number of small businessmen who maintain insurance agencies.

The CHAIRMAN. Thank you very much, Mr. Tye.

Mr. TYE. Thank you, Mr. Chairman, for this privilege.

Senator CARLSON. Mr. Chairman, I just want to say this, that I am very happy that Mr. Tye appeared here on behalf of the insur-

ance agencies, because I feel that this problem of taxing prepaid income is one that we thought we took care of in section 452 in the last Congress, or in the Revenue Act of 1954, and it is of great concern to me.

I was pleased to note that you mentioned the decision of the *Bureau* v. *the Wichita Beacon*, which is a newspaper in my home State. I am somewhat familiar with that situation, and it seems unfortunate that a corporation or a citizen has to go into court to get a decision in order to have the Treasury adjust their taxes. That is something I am going to give some more thought to as we go along here.

Mr. TYE. We felt that way in connection with *Brown* v. *Helvering*. In fact, in that case, the taxpayer argued in the alternative, either for prorating on a prepaid basis over the period of the policy or at least to deduce the reserve set up for the return commission, and the Supreme Court turned us down in two cases.

So, we have lived with it for 2 years, and now with the business of insurance being written more and more on a term basis, it has become a real problem for the private insurance agency, not just the large corporate agency.

The CHAIRMAN. Thank you very much.

(The following letter and enclosure was subsequently received for the record:)

NATIONAL ASSOCIATION OF INSURANCE AGENTS,
Washington, D. C., May 16, 1955.

MRS. ELIZABETH B. SPRINGER,
Clerk, Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: Would you please include the attached important letter as a part of the representation of this National Association of Insurance Agents before the Senate Finance Committee on H. R. 4725.

We think it extremely important to a very large number of small-business men throughout the country that Mr. Tye's letter appear in the printed record of the Senate Finance Committee hearings.

Please forgive the inked-in corrections in this letter from Mr. Tye. It was due to the fact that my secretary had this dictated by long-distance telephone and we are giving you the corrected letter in the interest of saving valuable time.

Cordially,

MAURICE G. HERNDON,
Washington Representative.

JOSEPH FROGATT & CO., INC.,
New York 2, N. Y., April 15, 1955.

Re reply to Ways and Means Committee agreement for repeal of section 452.

HON. COLIN F. STAM,
Chief of Staff, Joint Committee on Internal Revenue Taxation,
New House Office Building, Washington, D. C.

DEAR MR. STAMM: This representation is made on behalf of the National Association of Insurance Agents, a voluntary membership association numbering in excess of 32,000 insurance agency members. Included in this membership are an estimated 150,000 individuals, duly licensed by the respective States, who are proprietors, partners, or corporate principals in the firms and corporations which comprise said insurance agency members. The membership of this association is an important segment of the national economy, which has the practical and legal obligation of consummating and maintaining insurance protection for the majority of all individuals and business firms in the United States. This organization is comprised of independent businessmen who specialize in the production and servicing of policies of fire, casualty, surety, marine, and all other lines of general insurance for clients ranging from the smallest householder or automobile owner to the largest industrial corporation.

This association believes that section 452 dealing with prepaid income is peculiarly appropriate for equitable tax accounting of insurance agencies, and urges that, in substance, it be retained rather than repealed retroactively.

In this regard a report on H. R. 4725 by the House Ways and Means Committee cited as the sole ground for the repeal of section 452, the fear that taxpayers might obtain the 1954 tax reduction they expected under section 462 by changing the form of the transaction and qualifying for section 452 tax treatment. The report states on page 4: "Proposals have been advanced that the income-deferring provisions of section 452 should be retained in the law even though the estimated expense provisions of section 462 are repealed. It is contended that the revenue loss from section 452 is relatively insignificant in relation to the loss involved in section 462. Your committee has given careful consideration to the possibility of such action. *It has been advised by the Treasury, however, that if section 452 is not repealed at the same time 462 is repealed, a number of taxpayers who have reported a greatly reduced tax liability by electing the benefits of 462 would be able to accomplish the same result by electing to defer income under section 452.* For example, under section 462 it is possible to set up a reserve for estimated expenses attributable to fulfilling obligations of servicing and repairs under a product guaranty. If section 462 only were repealed, it would be possible for taxpayers, simply by changing the form of the transaction, to defer under section 452 that portion of income from the sale of the product which is attributable to the liability for future servicing and repair under the guaranty. It is, therefore, deemed necessary to repeal section 452 as well as section 462." [Italics supplied.]

In the first place, it is extremely doubtful whether it would be legally or commercially feasible for most taxpayers to change the form of their transactions so as to defer under section 452 income which they would have been able to offset, in part, by reserves for estimated expenses under section 462. Apart from the fact that taxpayers generally and insurance agents in particular do not have complete freedom of action as regards changing the form of a transaction (contractual obligations and the dual, rather than the unilateral, nature of transactions tend to prevent this) what the Treasury Department has obviously overlooked is the fact that it is no longer possible for taxpayers to change the forms of completed 1954 transactions already reflected in the taxpayer's records. There may be isolated fraudulent attempts in this respect, but it is submitted that such a possibility should not be the controlling factor in the final determination of whether section 452 should be repealed.

The law is set up so that 1954 is the important year not only from the taxpayer's standpoint but also from the Treasury's standpoint due to the protective provisions of the law granted to the Secretary of the Treasury. Thus, the taxpayer may elect without consent of the Secretary or his delegates only for the first year beginning after December 31, 1953, and ending after August 16, 1954. After the first year consent of the Secretary is a condition precedent to coming under section 452. It appears quite clear from the statute that any attempt to change the form of a 1954 transaction in order to qualify under section 452 would enable the Treasury to utilize its power under section 452 (d) (3) (b), and withhold its consent to the election of section 452 treatment of prepaid income.

It should, of course, be emphasized that there is no way the transactions of an insurance agency could be altered since all that is here involved is the receipt in 1 year of term commission on 3- or 5-year business. We believe such term commissions qualify as "prepaid income" within the scope of section 452 in that a liability to render services over the period of the policy legally exists, and that no change in the form of the transaction is or would be required to qualify under section 452. We believe that fears of the Treasury are unwarranted as respects taxpayers in general and insurance agents in particular since, as respects the latter, there is no casual relationship between the deferral of prepaid income under section 452 and the potential reserving for estimated return commissions in the event of cancellation or termination of the insurance policy prior to expiration under section 462.

However, if the Treasury is of the opinion that the congressional intent to distinguish unequivocally between section 462 items and section 452 items was not adequately expressed in the 1954 code, it would be more reasonable and realtistic for it to request retroactive clarifying amendment to section 452 rather than to write off what has been universally hailed as a sound tax accounting statute by retroactive repeal.

That insurance agency taxpayers hailed the enactment of section 452 is quite understandable since they have been plagued for over 20 years by the Supreme Court decision in the case of *Brown* v. *Helvering* (291 U. S. 193), which, largely based on the "claim of right" doctrine promulgated in *North American Oil Con-*

solidated v. *Burnet* (286 U. S. 417), denied to insurance agents the tax accounting treatment contemplated by section 452.

It is significant that even prior to the Internal Revenue Code of 1954, there was evidence of reluctance on the part of the courts to carry the previous judicial interpretations to the drastic lengths dictated by a continuance of the distortion inherent in the arbitrary application of the "claim of right" doctrine. For example, in a recent case involving an insurance agency, *Leedy-Glover Realty and Insurance Company* v. *Commissioner* (13 TC 95, affirmed 184 F (2) 833), the decision of *Brown* v. *Helvering, supra,* was distinguished in determining when income had been received for tax purposes, based largely on the showing of services to be rendered by the insurance agency. The court stated: "The facts are, however, that the commissions were not fully earned because of petitioner's obligation to service the policy over their full terms * * *."

Similarly in the recent case of *Beacon Publishing Company* v. *Commissioner,* decided on January 3, 1955, by the United States Court of Appeals for the 10th Circuit, the court did not follow the rationale of *Brown* v. *Helvering, supra.* The question presented in this case was whether sums received for prepaid newspaper subscriptions should have been included in the taxpayer's income for the year in which they were received or prorated over the unexpired subscription period. The court declared that the obvious purpose of sections 41 and 42 of the 1939 Internal Revenue Code was to obtain from the taxpayer a return reflecting its true income and to treat income received and deductible disbursements consistently. The court, as a practical matter, repudiated the "claim of right" doctrine as being inapplicable to many types of situations theretofore subjected to the doctrine. Rigid application of the "claim of right" doctrine would, in the court's opinion, result in a distortion of the taxpayer's taxable income in most cases. The court stated: "Plainly, section 42 (IRC of 1939) contemplates that prepaid sums can be returned in a year other than when received. It says that income shall be included in the taxable year received, 'unless other methods of accounting permitted under section 41 any such amounts are to be properly accounted for as of a different period.' This is not a case where the Commissioner has exercised his broad discretion to require a taxpayer to adopt an accounting method which will clearly reflect income, but is one in which he has improperly applied a legal principle."

We believe that the judicial trend is toward the view that tax provisions of the law should be in harmony with generally accepted accounting principles, which trend obviously had considerable bearing upon the deliberations of the Congress in the enactment of section 452. We do not believe that Congress should be stampeded into repealing a statute which covers accounting principle already sanctioned by the courts.

The question of the loss of revenue, of course, is one that must be considered. Although it would appear difficult, if not impossible, to predict or estimate what revenue losses there would be in 1954, section 452 contemplates that all the income would be taxed, the only question is which year or years. In this sense there is no "windfall" involved as that term was used in the hearings. We should also point out the great majority of the members of this association are in the category of small business, and it is doubtful whether the loss of revenue in 1954 from this source would be at all significant.

In conclusion, it is respectfully requested that serious consideration be given to the retention of section 452 either in its present form or with retroactive clarifying amendments, for the following reasons:

(1) It is doubtful, as a practical and legal matter, that the form of 1954 transaction could be changed for the sole purpose of qualifying under section 452.

(2) If an attempt is made to change the form of transaction, we believe consent to using section 452 could be withheld by the Secretary or his delegate.

(3) The judicial trend is toward preservation of the accounting theory evidenced by section 452.

(4) The revenue loss in 1954, as respects this association, would not be significant and there would be recoupment since there is no doubt that all prepaid income would ultimately be included in gross income (within 3 or 5 years).

Respectfully yours,

CHARLES W. TYE,
Special Tax Consultant, National Association of Insurance Agents.

The next witness will be Charles W. Stewart, Machinery and Allied Products Institute.

Mr. Stewart, you may be seated and proceed.

STATEMENT OF CHARLES W. STEWART, JR. EXECUTIVE VICE PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. STEWART. Mr. Chairman, my name is Charles W. Stewart, Jr. I am executive vice president of Machinery and Allied Products Institute.

The institute has a statement which, if the Chair please, we will submit for the record, and I should like to underline one or two portions of it in order to conserve your time.

The CHAIRMAN. That is fine. It will be inserted in the record.

You may proceed, sir.

Mr. STEWART. I have with me Mr. Brown of our staff.

Mr. Chairman, we feel somewhat concerned about appearing here because we feel obliged to be rather critical of the way the section 462 matter has been handled from the administrative standpoint. I say we feel somewhat concerned about appearing in criticism because we respect so much the work that has been done in connection with the 1954 code as a whole by the staff of this committee and the staffs of the Treasury and Internal Revenue Service.

We will not comment on the proposition presented by Senator Gore yesterday morning, although we have definite views on it, because we assume that is not before the committee for decision in connection with 462 and 452.

Our statement, which is before you, has attempted to meet the points raised by Secretary Humphrey of the Treasury in his presentation yesterday. For purposes of emphasis, I should like to read one section of our statement which we believe, in order to put sections 462 and 452 in perspective, must be returned to at all times.

I refer to the language beginning in the second paragraph on page 7 where we say:

> * * * we feel compelled to dispel what we believe is an entirely erroneous impression which may have been created by Secretary Humphrey's statement before this committee. Briefly, the purport of his testimony was that taxpayers have attempted to take advantage of an unintended double tax deduction and were on notice that the Treasury intended to repeal the law before they acted to their detriment. He then concludes that the proposed retroactive repeal would result in prejudice to no one. A simple review of the chronology of events which transpired since the passage of the Internal Revenue Act of 1954—

we feel—

> will do much to clarify the situation.
>
> The Code was enacted on August 16, 1954. Both sections 462 and 452 were adopted without opposition. However, while the Congress was apparently in complete accord as to the type of expense intended to be covered under section 462, the language of the statute itself—as we have suggested heretofore—was extremely broad. Taxpayers were faced with the difficulty of determining which expenses were proper and allowable under the provision as drafted. The difficulty was compounded in view of the statutory requirement that the taxpayer apply the provisions of 462 to all items susceptible to reserve treatment—

which is the so-called all-or-nothing rule.

> Under these circumstances it is natural that taxpayers should look to regulations for guidance prior to exercising the election. These regulations were not issued, even in tentative form, until Saturday, January 22. In the meantime, the Internal Revenue Service took two steps which had the effect of forcing taxpayers to make their election.
>
> The first of these was Revenue Ruling 54-608, narrowing allowable vacation expense deductions for accrual-basis taxpayers. Many taxpayers who heretofore had deducted vacation pay were now forced to establish reserves for this item

under section 462. Indeed, in a few cases which have been brought to our attention, taxpayers made an election under section 462 to establish reserves for all allowable items solely because of this change in Revenue Service policy. The Secretary, in his testimony before this committee, had dismissed this problem by noting that this ruling was subsequently suspended. This ignores the fact that the issuance of this ruling forced certain companies to act to their present detriment and even now is suspended only until the end of 1955, when, presumably, many taxpayers will be prohibited from taking any deduction for part of their vacation pay.

The second step by the Commissioner of the Internal Revenue Service was an announcement on January 5 requiring all taxpayers electing to avail themselves of either section 462 or 452 to enter such items on their regular books of account and to reflect them in their financial statements to stockholders, creditors, et cetera. Thus, many firms, faced with the necessity of closing their books for the year, issuing financial statements, and declaring dividends, were forced to act on their best judgment, prior even to seeing the proposed Treasury regulations.

Finally, 1 month after the regulations were issued in tentative form, the Treasury made its recommendation to this committee for the complete and retroactive repeal of both sections 452 and 462. There was no warning whatsoever to those companies on a calendar year accounting basis. Some companies, in fact, faced with having to make an immediate decision, acted on specific advice of the Internal Revenue Service and—entirely in good faith—established reserves on their books, reflected them in their financial statement to their creditors and stockholders and made financial commitments for the year.

In answer to those who might interject at this point that taxpayers should have waited until a subsequent tax year when the matter was clarified, it should be noted that prior to the regulations there was no indication that a taxpayer could wait until a subsequent year without imposing on himself the added burden of obtaining consent from the Secretary for a change in accounting method.

The most bewildering aspect of this unfortunate series of events is the question of why the Treasury, after waiting over 5 months to issue their proposed regulations, decided a month later to request outright repeal. It is undoubtedly true that the Treasury was revising its revenue loss estimates during the autumn, and quite understandably, albeit belatedly, became more and more concerned over the magnitude of the revenue problem.

Now, diverting from the statement, it is with that background in mind that I should like to call the attention of the committee to a series of questions which I shall ask in a rhetorical way and then answer rather briefly, if I may, so as to point up what we think are the real issues involved here.

In the first place, did the Congress and the Treasury Department intend a double deduction in the broad sense? We feel, contrary to Secretary Humphrey's implication yesterday, that there is no question that the Congress recognized that in the first year of transition there was and should be a double deduction contemplated. The report of this committee so states.

The second question is whether or not there is misunderstanding as to what type of double deduction is involved. Is it a double deduction in the invidious sense or in the "windfall" sense, or is a matter of transition where, for different expenses or for expenses of a different character, it so happens that there is a concentration of deductions in 1 year? We believe it is the latter.

Isn't the type of revenue transitional problem involved here present elsewhere in the code, and haven't we had experience with it? We think the answer to that is clearly, yes. The American Institute of Accountants' testimony yesterday referred to 1 or 2 examples, and we should like to underline for the committee a further example, working on the other side of the fence; namely, the matter of accelerated corporate taxpayments. There was a concentration or doubling up of

effects in the first years of transition, only in that case the benefit fell on the side of the Government.

Was business on notice as to the Treasury's intentions? We answer that unequivocally, no, as far as repeal is concerned, and we cite as evidence the history which I have just brought to the attention of the committee. On the contrary, business had every reason to believe that the Treasury would not recommend repeal of the law prior to Secretary of the Treasury Humphrey's letter to the Ways and Means Committee.

Did business act in good faith on the statute and to its detriment? Certainly it acted in good faith, particularly as to calendar-year taxpayers. In some instances it may have acted to its detriment because it made management decisions which might have been decided differently if any change in 462 had been indicated in advance.

Did Government magnify and aggravate the administrative problem and revenue problem by administrative action and other procedures? We think clearly, yes. Taxpayers were forced to make decisions on a calendar-year basis by the regulations to which I refer.

Hasn't the Treasury overlooked the obvious solution; namely, to legislate the proposed regulations? We feel, yes. We feel that the Secretary would not deny the proposition that the regulations, or the content of the regulations, to which taxpayers took objection because they did not follow the language of the law, did represent the view of what the Treasury thought Congress intended in the first instance.

If so, doesn't it make sense to amend the law to conform to the original intent of this committee as expressed in its report, as distinguished from statutory language, and to conform to the general outline of the regulations themselves?

As to dimensions of the revenue loss, we have not yet been informed publicly of what the Treasury estimate is. A much smaller amount than has been talked about loosely has been submitted to this committee for its consideration by the American Institute of Accountants, and I should like to call to the attention of the committee a partial explanation as to why, at least as far as capital-goods businessses are concerned, the amount of probable loss in revenue is not as much as suggested by those favoring repeal.

Some companies just did not believe that it would be desirable to plan on establishing reserves. Many companies would not exercise the election during the first year so that the impact of the revenue loss would automatically be spread out over 2 years. Many companies had previously been accruing vacation pay and, therefore, reserves for such items as vacation pay would not represent an increase in revenue loss. And, finally, and most important, based on an informal check which we made with capital-goods companies, all of the companies that we contacted intended to stay within the scope of the proposed regulations by the Treasury rather than establishing reserves for the items which concerned the Secretary from a revenue standpoint, such as maintenance and expense.

The final question, and one about which we are particularly concerned, is this matter of whether or not there isn't a broader question involved here with respect to basic tax and administrative principles. We feel that if this practice of retroactively repealing a statute, in the face of the administrative history which I have asked to be included in the record, is continued, we will remove from the tax structure a

very vital part of our system in this country, namely, certainty in the tax laws.

This will raise questions in the minds of taxpayers and, furthermore, you will place businessmen in the position of not being able to make decisions with reasonable foresight and with reasonable belief that tax law will remain the way it was legislated at least for a reasonable period of time.

In general, we feel that section 462 has been the victim of an unfortunate series of events. We feel that it has been surrounded by misunderstanding and misinterpretation; and that there is a way to correct it and that that way has been pointed out, not only by us, but by other groups.

Specifically we submit that this committee should give attention to the possibility of amending the law in accordance with our specific recommendations which are set forth in detail, beginning on page 13 of our statement:

Limit the allowable expenses to those liabilities specifically recommended in the congressional report; provide that the revenue loss resulting from the reserves be spread over a 3-year or longer period at the discretion of the committee; eliminate the all-or-nothing requirement in the elections; and modify the requirement that the taxpayer must make his election in the first taxable year by June 30, 1955, to avoid obtaining special approval of the Commissioner.

Thank you.

The CHAIRMAN. Do you feel that the adoption of those recommendations would reduce the loss as compared with that resulting from the two sections as they now stand?

Mr. STEWART. Very substantially, sir.

The CHAIRMAN. How much?

Mr. STEWART. Well, certainly it would reduce the total loss to an amount in the general neighborhood suggested by the American Institute of Accountants. Perhaps a little more, but if spread over a long period of time, we think the revenue system could take it.

The CHAIRMAN. Well, was not their estimate approximately $500 million?

Mr. STEWART. That is right, sir. However, spread over a period of 3 to 10 years, taking into consideration the objectives involved, the soundness of the principle, and the fact that it was legislated and acted upon, we respectfully think that is the course that the Congress should take. May I suggest, in addition, that if Congress does repeal section 462, careful consideration should be given to the technical relief provisions proposed by the American Institute of Accountants and by other groups. Moreover, we respectfully suggest that the report of this committee might call attention to the chronology of the administrative history of section 462 and urge that the administrative lessons to be gained from this experience should be borne in mind by the Treasury and Internal Revenue Service in the future so as to avoid inequities and confusion among taxpayers.

The CHAIRMAN. Thank you, Mr. Stewart.

Any questions?

Senator CARLSON. No questions.

The CHAIRMAN. Thank you very much.

Mr. STEWART. Thank you, sir.

(Mr. Stewart's prepared statement follows:)

THE PROPOSED REPEAL OF SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954—STATEMENT OF MACHINERY AND ALLIED PRODUCTS INSTITUTE, CHICAGO, ILL., PRESENTED BY CHARLES W. STEWART, EXECUTIVE VICE PRESIDENT

Mr. Chairman and gentlemen of the committee, we appreciate the opportunity to submit the views of the Machinery and Allied Products Institute on the proposed repeal of sections 452 and 462 of the Internal Revenue Code of 1954 (H. R. 4725).

Speaking on behalf of the capital goods industries of the United States, we would like to register with your committee our strong opposition to the proposed repeal of sections 452 and 462 of the Internal Revenue Code of 1954. This drastic action proposed by the Treasury and approved by the House Ways and Means Committee is, in our judgment, both unnecessary and inequitable.

In our oral and written statements before the House Ways and Means Committee, which are available to this committee, we set forth, at some length, our objections to outright repeal and our proposals for amending the present code provisions to remove objectionable features arising from the provision as presently drafted. You have heard testimony from some of the country's leading tax accountants explaining the merits of these two sections enacted into the 1954 code and the inevitable injustices which would arise from their retroactive repeal. We will, therefore, not impose on you by reiterating the many sound reasons for their original adoption. Instead, we should simply like to address ourselves to the issues which are raised by the Treasury in its recommendations to this committee and to clarify some of the misconceptions which we respectfully submit arise from Secretary Humphrey's testimony yesterday.

We are all agreed on the general desirability of bringing tax accounting into conformity with sound business accounting practices. The objectives which the Congress had in mind in adopting these two provisions have never been, to our knowledge, seriously challenged. From the beginning there have been only two principal reasons advanced for retroactively repealing these provisions. These are the greater-than-anticipated loss of revenue during the year of transition and the concern of the Treasury that some taxpayers may be successful in applying section 462 to large expense items apparently not contemplated within the original scope of the provision. We shall first deal with the question of revenue loss.

Inasmuch as there is no indication of an inordinate loss of revenue expected to result from section 452—prepaid income—and the only reason that has apparently been advanced in support of its repeal is that it might be used improperly in the event that section 462 is eliminated, we will not dwell on the incontrovertible merits of this provision. We will center our attention on the loss of revenue resulting from section 462, which provision is more directly applicable to capital goods situations.

Before stating our views in detail, we should like to make it clear that we do not wish to be captious with respect to the manner in which the sections 452 and 462 question has been dealt with by the Treasury Department. Certainly it is necessary at times, when you look back on the history of a provision of this type, which is highly complicated and technical in character, to suggest that it should have been handled differently. But we are fully aware of the complexity of tax legislation and tax administration. Moreover, we appreciate fully the great achievement which the Internal Revenue Code of 1954 as a whole represents.

Secretary Humphrey was quite correct in stating it was not intended that these provisions serve as a radical tax reduction. That there would be an unavoidable loss of revenue, however, during the period of transition was anticipated and recognized by all concerned. It was this committee which inserted a provision in the Internal Revenue Code specifically allowing the doubling up effect during the year of transition. The American Institute of Accountants brought the problem to the attention of this committee at the time it was considering H. R. 8300 and suggested means of dealing with it. Presumably because of the fact that the estimated closs of revenue was placed at only $47 million, this committee determined that a spreading of the revenue loss was unnecessary. Thus, we cannot agree with the Secretary of the Treasury when in response to questions of this committee he suggested that there never was an intent to allow what he referred to as this "double deduction."

To begin with, there is in fact no "double deduction." No one gets a particular deduction twice. As a result of taxpayers being able to deduct, in the year of transition, those expense items which—because of bad case law—they have

heretofore had to postpone until they became fixed and payable, along with the actual deduction of the current year, a bunching up of expense deductions would occur in a single year. This is all that is involved here. True, the Treasury significantly underestimated the amount that was involved in such expense items as vacation pay, product warranties, service guaranties, etc. But it is only this additional impairment of the revenue, resulting from the generally intended and perfectly legitimate use of section 462 which is the problem involved here. Recognizing this, we cannot understand the reference to it in the Secretary's statement as a "windfall" to the taxpayer.

The revenue problem can be dealt with simply and effectively by spreading out the deduction for the expense reserve over whatever period of time is thought necessary. This will reduce the transitional loss in any one tax year.

There appears, however, to be a tendency on the part of the Treasury and others to confuse the loss of revenue which would result from the intended application of 462 with the greater and entirely unanticipated loss of revenue which might result from successful litigation by those taxpayers claiming expenses prohibited by the proposed regulations. It is important to distinguish between the two and deal with each on its own terms.

The answer to the problem of scope of coverage is a relatively simple one and one which has been repeatedly proposed by us and other groups testifying before this committee. Specifically, we have suggested an amendment to the present code provision enumerating and limiting allowable items of expense. By adopting this type of amendment, most of the costly litigation now anticipated by the Treasury can be eliminated and the revenue loss more accurately estimated and kept within predetermined bounds. As of this date, we are not aware of any attempt by the Treasury to distinguish between the two problems and separately estimate the anticipated loss of revenue resulting from the proper application of the proposed regulations. Indeed, it will be noticed that almost the entire argument which the Treasury has presented to this committee in reiterating its demand for retroactive repeal rests on the contention that many taxpayers are intending to establish reserves for expenses not originally contemplated in section 462.

We submit that it is inadvisable for Congress to act on the Treasury proposal until such time as the Treasury clearly differentiates between the two types of loss here involved. The estimate of $150 million made by the American Institute of Accountants after a considerable amount of research and sampling appears to be more realistic than many of the estimates heretofore suggested.

It should be noted that the impact of the transitional loss resulting from establishment of reserves for the type of expenses unquestionably intended by Congress was further increased and concentrated by what we believe were two unnecessary statutory requirements as the section is presently drafted: (1) that a taxpayer electing to establish reserves for certain obvious expense items must also set up reserves for all expenses susceptible to reserve treatment under section 462, and (2) that the taxpayer could make a free election in its first taxable year and would have to obtain special approval of the Commissioner to switch in any year thereafter. This latter point was tactfully modified by the Treasury in its proposed regulations to encourage postponement of the election until the second year.

Leaving aside the "windfall" or "double deduction" misconceptions and recognizing that this loss is not only nonrecurring, but may be spread out over whatever period of time is deemed appropriate, there may be a tendency on the part of some to search for a means by which these highly desirable objectives can be obtained without any attendant loss to the Treasury. The Congress, of course, did not take this approach originally in adopting these two sections. However, taxpayers themselves were confronted with a similar dilemma in appraising the Treasury's desire to accelerate corporate tax payments so as to bring Treasury receipts from corporate revenue more closely up to date with corporate income receipts, a modified pay-as-you-go system. Both the Mills plans and the schedule incorporated in the 1954 code, which would further accelerate corporate tax payments, have the effect of requiring taxpayers, during the years of transition, to pay more than 100 percent of their yearly tax liability. Although this had adverse effects on the financial status of some companies and meant an indefinite postponement of any recoupment of this overpayment, business generally did not challenge either the validity or the operation of this change in collection periods.

Although it has the actual effect of a tax increase for the corporate taxpayer, responsible business groups have not requested that the Congress repeal these provisions. The transition is to be accomplished over a 5-year period. In the language of the Senate Finance Committee report on H. R. 8300, this "* * * will afford the business community ample opportunity to adjust to the new system * * *." We respectfully suggest that should this committee spread the

effects of sections 452 and 462 over a period of years the Federal Government will be able to adjust to the revenue loss involved.

Before setting forth our specific recommendations, we feel compelled to dispel what we believe is an entirely erroneous impression which may have been created by Secretary Humphrey's statement before this committee. Briefly, the purport of his testimony was that taxpayers have attempted to take advantage of an unintended double tax deduction and were on notice that the Treasury intended to repeal the law before they acted to their detriment. He then concludes that the proposed retroactive repeal would result in prejudice to no one. A simple review of the chronology of events which transpired since the passage of the Internal Revenue Act of 1954 will do much to clarify the situation.

The code was enacted on August 16, 1954. Both sections 462 and 452 were adopted without opposition. However, while the Congress was apparently in complete accord as to the type of expense intended to be covered under section 462 the language of the statute itself—as we have suggested heretofore—was extremely broad. Taxpayers were faced with the difficulty of determining which expenses were proper and allowable under the provision as drafted. The difficulty was compounded in view of the statutory requirement, noted above, requiring the taxpayer to apply the provisions of 462 to all items susceptible to reserve treatment.

Under these circumstances it is natural that taxpayers should look to regulations for guidance prior to exercising the election. These regulations were not issued, even in tentative form, until Saturday, January 22. In the meantime, the Internal Revenue Service took two steps which had the effect of forcing taxpayers to make their election.

The first of these was revenue ruling 54-608, narrowing allowable vacation expense deductions for accrual-basis taxpayers. Many taxpayers who heretofore had deducted vacation pay were now forced to establish reserves for this item under section 462. Indeed, in a few cases which have been brought to our attention, taxpayers made an election under section 462 to establish reserves for all allowable items solely because of this change in Revenue Service policy. The Secretary, in his testimony before this committee, has dismissed this problem by noting that this ruling was subsequently suspended. This ignores the fact that the issuance of this ruling forced certain companies to act to their present detriment and even now is suspended only until the end of 1955, when, presumably, many taxpayers will be prohibited from taking any deduction for part of their vacation pay.

The second step by the Commissioner of the Internal Revenue Service was an announcement on January 5 requiring all taxpayers electing to avail themselves of either section 462 or 452 to enter such items on their regular books of account and to reflect them in their financial statements to stockholders, creditors, etc. Thus, many firms, faced with the necessity of closing their books for the year, issuing financial statements, and declaring dividends, were forced to act on their best judgment, prior even to seeing the proposed Treasury regulations.

Finally, one month after the regulations were issued in tentative form, the Treasury made its recommendation to this committee for the complete and retroactive repeal of both sections 452 and 462. There was no warning whatsoever to those companies on a calendar year accounting basis. Some companies, in fact, faced with having to make an immediate decision, acted on specific advice of the Internal Revenue Service and—entirely in good faith—established reserves on their books, reflected them in their financial statement to their creditors and stockholders and made financial commitments for the year.

In answer to those who might interject at this point that taxpayers should have waited until a subsequent tax year when the matter was clarified, it should be noted that prior to the regulations there was no indication that a taxpayer could wait until a subsequent year without imposing on himself the added burden of obtaining consent from the Secretary for a change in accounting method.

The most bewildering aspect of this unfortunate series of events is the question of why the Treasury, after waiting over 5 months to issue their proposed regulations, decided a month later to request outright repeal. It is undoubtedly true that the Treasury was revising its revenue loss estimate during the autumn and quite understandably, albeit belatedly, became more and more concerned over the magnitude of the error.

Certainly, between the time the code provision was enacted and the regulations were issued implementing these provisions, there was ample opportunity to study the problem and take whatever corrective steps were necessary. Indeed, contrary to the impression which the Secretary raised in his testimony yesterday, most

taxpayers took the issuance of the proposed regulations combined with the administrative requirements imposed by the Internal Revenue Service as a clear indication that there were no changes contemplated. Even with the benefit of hindsight and the recital by the Secretary of the thinking of the Treasury staff, it is difficult to see how any contrary conclusion could have been reached by the taxpayer.

The Secretary stated before this committee that "Before the end of the year, studies by the Treasury staff, working with the staff of your committee (Senate Finance Committee) were undertaken to see if the threatened situation could properly and effectively be cured by regulation * * *." Certainly, the regulations could not have been conceived as a means of reducing the revenue loss arising from the deduction of those items of expenses specifically intended by the Congress in enacting section 462. Obviously the only objective could have been to restrict the scope of the provision to the specific examples in the committee reports and to place reasonable safeguards on the methods of estimating and revising the reserves.

According to the Secretary's testimony, many taxpayers challenged the right of the Treasury to confine the scope of section 162 to the examples in the regulations. We would like to observe in passing that not one of more than 100 capital goods companies of all sizes which were polled informally by MAPI at the time of the issuance of the regulations proposed to establish reserves for any items not clearly within these regulations. Indeed, most of the criticism of this provision of the code came from the necessity of establishing some reserves which taxpayers had no desire to so treat. At this point it appears to us that the Treasury had two alternatives before it. The first was simply to stick with the regulations and to attempt their successful defense in the courts. The second, and in our minds the more desirable, was to come before Congress and request the type of amendment which the business and tax groups testifying before this committee during the past 2 days have universally recommended.

Instead, the Treasury suddenly requested the drastic remedy of retroactive repeal because, in the words of the Secretary, "* * * the original objective might not be carried out and * * * the situation could not be adequately corrected by regulation * * *." The question might properly be asked at this point what the "original objective" was that the Treasury had in mind. Nothing could have developed between the time the regulations were issued and the request for repeal was made to justify this reversal of policy. There existed as much data prior to the issuance of the regulations as subsequently to indicate the magnitude of the loss. The only possible change was a challenge through litigation of the scope of the regulations.

The question and full implications of retroactive repeal have been treated entirely too lightly, in our opinion, particularly since this is a tax matter. In our judgment retroactive changes in tax laws or procedures inevitably will serve to remove the element of certainty from tax statutes, and undermine the confidence of taxpayers, and put business decisions on dead center.

Some examples of irrevocable prejudice to taxpayers resulting from repeal of these provisions have been brought to the attention of this committee and there are probably many, many more. Presumably, the Congress, in its wisdom, might adopt special provisions to alleviate the effect in each type of situation which is brought to their attention. But of far greater importance, we submit, is the irreparable impairment to the confidence which the business community must have in the administration of our tax structure. To require management to withdraw and retrace the many steps they took entirely in good faith and on the basis of clear statutory authority can not help but introduce an element of uncertainty and cynicism in the minds of all taxpayers. The series of events culminating in retroactive repeal can never place every one in the position they would have been had the provisions not been enacted. You just can't wind back the clock.

To summarize, we believe that if the principles embodied in sections 452 and 462 were sound when adopted, they are equally sound today, regardless of the unanticipated impairment of revenue resulting from section 462 as it now stands. It would appear that the present concern arises out of two principal points: (1) The breadth of the statutory language, and (2) the amount and concentration of the transitional revenue loss. We contend that remedial legislation can, and should, be drafted at this time to retain the basic objectives of this provision and yet eliminate the threat of extensive litigation, prevent any inordinate loss of revenue and spread the anticipated loss of revenue over a longer period of

time. Our recommendations, briefly set forth below, are designed to achieve this purpose:

1. *Limit the allowable expenses to those liabilities specifically recommended in the congressional reports.*—The language of section 462 should be amended to limit expenses for which a reserve may be established to the types of expense suggested in the committee reports. This could be accomplished by enumerating those examples which were included in the committee reports and subsequently in the proposed Treasury regulations. In addition, a proviso permitting the Commissioner, in his discretion, to allow certain other enumerated expense items should be included. The Secretary of the Treasury has indicated that he feels the clause in the present section 462, giving him certain discretion in the reasonableness of additions to reserves, is not broad enough to cover the propriety of the establishment of a reserve itself. We believe that his discretion is broad enough, under the existing provision, but we would have no objection to its being clarified. However, should the Congress adopt our suggestion of enumerating expenses, the need for this discretionary authority would seem to be superfluous.

We are aware of the fact that, by thus limiting allowable expenses to those which are in the nature of liabilities to other persons, an artificial line may be drawn in individual cases, and certain expenses which taxpayers in some industries have heretofore been reserving under sound accounting principles may continue to be disallowed for tax purposes. However, in view of the understandable concern over attendant revenue loss, this would appear the only practical means available at this time for eventually achieving harmony between tax and business accounting practices. This amendment would, in effect, be in the nature of a validation of the proposed Treasury regulations which, by and large, reflected the committee language.

2. *Provide that the revenue loss resulting from the reserves be spread over a 3-year period.*—In view of the general concern over the loss of revenue during the transitional period, it would appear desirable and entirely feasible to incorporate provisions in section 462 requiring the taxpayers electing to establish reserves to spread the tax effect over an extended period of time. We have suggested 3 years, but the Congress itself, after having reappraised the expected loss of revenue from these sections as amended, will be in the best position to decide what period of time is most desirable. We are not suggesting the means by which this would be achieved in view of the fact that there are many alternatives available, such as allowing a fractional addition to each year's reserve or the spreading of the actual deduction of the transitional year over the succeeding year. This is a matter upon which the technical experts of this committee, the Treasury, and the professional groups testifying before your committee are in a far better position to make recommendations, keeping in mind the practicality and the east of application by the taxpayers.

3. *Eliminate the all-or-nothing requirement in the election.*—Experience with capital goods companies indicates that most companies would prefer establishing reserves for only a few noncontroversial items such as vacation pay, warranties, returns, and the like, and that they would prefer not to set up additional reserves for every conceivable item that might properly come within the scope of the present section 462. Unfortunately, the present language of the statute would require a taxpayer to follow the latter course. In many cases, the total reserve figures have been unnecessarily increased by this requirement. In addition, this all-or-nothing requirement has made the Treasury policy of requiring taxpayers to book all reserves extremely onerous in many instances. The removal, therefore, of this provision would also have the virtue of eliminating many of the objections to the booking requirement. It is recognized, however, that should the statute be amended to enumerate only certain specific items, much of our difficulty which arises from the all-or-nothing requirement would be eliminated and similarly our objections to booking all such reserves would, for the most part, disappear.

It may be contended that, if the purpose of the provision is to bring tax accounting into harmony with sound accounting principles, providing the taxpayer with an election to establish reserves only as to certain items, would, in fact, further distort this relationship. In our opinion, taxpayers should be required to establish reserves only where they feel that such a treatment of an item is consonant with sound accounting practice in their business and industry.

4. *Modify the requirement that the taxpayer must make his election in the first taxable year or by June 30, 1955, to avoid obtaining special approval of the Commissioner.*—In view of the desirability of spreading this transitional revenue loss over a longer period of time, the Congress might find it appropriate to permit

taxpayers a free election at a future date. Elimination of the present incentive to early election to avoid special consent of the Commissioner would almost certainly result in spreading the transitional revenue loss over a longer period of time. The proposed Treasury regulations would allow taxpayers to make this election during their second taxable year providing they indicated to the Treasury their decision to do so prior to June 30, 1955. In any case, a reasonable extension of this free election should be granted either by Treasury regulation or by statutory provision, especially in view of the confusion which has surrounded this highly technical provision and the further delays that will result before amendments can be adopted and regulations finalized.

The CHAIRMAN. The next witness will be Francis R. Cawley, vice president of the Magazine Publishers Association, Inc.

STATEMENT OF FRANCIS R. CAWLEY, VICE PRESIDENT, MAGAZINE PUBLISHERS ASSOCIATION, INC.

Mr. CAWLEY. Mr. Chairman, my name is Francis R. Cawley. I am vice president of the Magazine Publishers Association, Inc., and in such capacity I represent 400 general interest, agriculture and business magazines. I am grateful for this opportunity to present to your committee the views of my association on the proposed repeal of sections 452 and 462 of the Internal Revenue Act of 1954.

While we are principally concerned with section 452, we know that the adoption of both these sections by the last Congress was an integral part of a measure to simplify and improve tax accounting procedures so that business accounting and tax accounting could be maintained on a uniform basis.

I might say right here that we oppose the repeal of both of these sections because of the principles involved.

We did not consider the enactment of these two sections as providing a loophole through which the industry could obtain radical tax reductions. Nor have they had that effect.

The enactment of section 452 merely codified important trade practices and existing rulings of the Treasury Department in the magazine-publishing industry which have existed for many years. Throughout this period about 95 percent of our publishers have operated on a deferred income basis under rulings of the Treasury Department.

Therefore, the repeal of section 452 will not materially affect the tax revenue received from our industry. I am confident that if you made an analysis of the entire publishing industry, including all magazines and newspapers, you would find that the postponement of revenue to be obtained by the Treasury Department for calendar year 1954 is well within the amount originally recognized as the possible deferment of tax receipts during the first year of this law's operation.

The CHAIRMAN. Do you believe the present bill assures the return to the situation that existed before these two sections were adopted?

Mr. CAWLEY. Mr. Chairman, in view of the language which accompanied the repeal of these sections in the House, I believe it takes care of part of the industry. But, my plea here is for universal recognition of the right to defer unearned subscription income.

The CHAIRMAN. That was not the question. A witness here today testified that if these two sections were repealed, that we would not revert back to the situation that existed exactly before they were adopted.

Do I understand you to say a number of your magazines and others are already getting the benefit of the deferred income basis.

Mr. CAWLEY. Mr. Chairman, as it now stands, I am confident that for a good number of our publishers, we would revert back to the former practices before the act of 1954. We have had that assurance from the Secretary of the Treasury.

The CHAIRMAN. What percent of your publishers would be affected if these sections were repealed?

Mr. CAWLEY. Mr. Chairman, if they are repealed and we revert back to former practices, about 5 percent of our publishers.

The CHAIRMAN. 95 percent are taken care of?

Mr. CAWLEY. Yes, they are, under prior practices.

Senator CARLSON. Mr. Chairman, right on that point, that is a situation I am somewhat familiar with because of this Wichita Beacon case.

It seems unfair that just because a certain group of publishers got in under a certain statute and others came in later and did not qualify at the time, that they should be penalized. This particular corporation has been in 2 or 3 courts, and they won a decision in January of this year, I believe it was, in Denver, a 2-to-1 decision in a 3-judge Federal court, and I have heard some rumors circulating around that if this section is repealed that the Treasury is again going to put these people into court. It seems to me that on the basis of all fairness that it ought to spread universally, it ought to apply to all these people.

Mr. CAWLEY. Mr. Chairman, I want to make it clear that I speak for only 400 magazines. There are considerably more than that in this country.

Therefore, since the enactment of section 452 codified a trade practice recognized by the Treasury Department for many years, and since it does not materially affect Treasury revenues, we sincerely believe that its retention, at least for the publishing industry, would not give rise to any serious questions. Our plea is for universal recognition of the right of publishers to defer subscription income. Section 452 accomplished this. Its repeal will place some segments of the industry in a highly inequitable position and is unjustly discriminatory against those companies not now on a deferred basis.

Prior to 1938 some publishers reported as taxable income in the year of receipt all subscription moneys received, regardless of the period or periods covered by the subscriptions. In other cases the publishers allocated income received over the period of the subscription and reported income on that basis. The Bureau of Internal Revenue in 1938 issued a ruling which held that regardless of the method of accounting in use by the publishers, subscription income was taxable in the year received and could not be allocated over the period of the subscription.

This order was subsequently revised, and in 1940 the Bureau issued I. T. 3369 in which it was held that both methods of accounting for subscription income would be recognized. The effect of this ruling was that publishers which had previously adopted the method of reporting subscription income as earned could continue on that basis. Others had to report their income on the basis of receipts.

The inequities and confusion of this situation are apparent: For example, 2 taxpayers engaged in the same business and keeping their

books in the same way could be required to report subscription income on different bases, because 1 taxpayer had prior to 1940 adopted the method of reporting such income as earned, while the other had adopted the method of reporting such income as received. We believe that it is grossly unjust, grossly discriminatory, and possibly unconstitutional, to segregate taxpayers by date with the result that a relative few taxpayers in the industry are compelled to report subscription income on a different basis from that of the great majority.

Under the prior practice of the Treasury Department certain publishers thus are required to pay tax on income before it is really earned and bear the expense of servicing those subscriptions in subsequent years. In fairness to all, the manner of reporting subscription income on an accrual basis should be equalized. The publishing industry should be permitted to adopt uniform accounting practices in this respect.

Magazine subscription income is not earned until deliveries of the magazine are effected. An analysis of the Audit Bureau of Circulations' statements for 132 general magazines of over 100,000 circulation disclosed that approximately 75 percent of subscription income applies to copies which must be printed and delivered in subsequent taxable years.

Consistent with this practice of deferring subscription income, our publishers have also deferred editorial, production, manufacturing, and distribution expenses related to a particular issue distributed. These constitute the vast bulk of publishing expenses. On an accrual accounting basis this is a proper deferment of expenses and has been recognized and approved by the Treasury Department.

If section 452 cannot be retained, as we hope it will, the effect of this repeal should not interfere with the accepted practice in the publishing industry of treating the advance payments on subscriptions as deposits to be taken into income as earned. The Treasury Department should continue and extend its current practices and rulings as related to publishers.

The basic reason of the Treasury for requesting the retroactive repeal of sections 452 and 462 was that the presence of these two sections in the law "will cause a greater loss in revenue than estimated * * *" Corporate tax collections for March 1955, as reported by the Treasury Department, however, were approximately $383 million in excess of the estimates of the Treasury Department made as of August 1954. On this basis the tax collections for the full year are indicated to be far in excess of the original estimates. Therefore, this reason advanced for the repeal of sections 452 and 462 appears to have been unfounded.

It would seem an unfortunate step to undo the good work accomplished by sections 452 and 462 of the Internal Revenue Act of 1954. We believe it is possible to narrow or restrict the application of these sections consistent with the legislative history supporting the enactment so as to reduce the loss potential cited by the Treasury Department. We believe these modifications could be adopted without the necessity of outright repeal.

The CHAIRMAN. Thank you very much, Mr. Cawley.

Senator CARLSON. Mr. Chairman, just a moment, if I may?

As I understand it, Mr. Cawley, the Bureau of Internal Revenue allows deferred income. And also deferred expenses for editorial production, manufacturing and distribution generally?

Mr. CAWLEY. Yes, sir.

Now in a situation where your income is not permitted to be deferred, you are paying taxes on income before you really know what you have actually earned on that income.

Senator CARLSON. Then just following that same statement, the newspaper that took advantage of the opportunity previous to 1940 to defer their taxes on income, prepaid income, get the advantage of subscription income plus these other items, while other newspapers could not take advantage of deferred income.

Mr. CAWLEY. As it relates to income, that is correct, Senator.

Senator CARLSON. That is the point that I think is rather important in this discussion.

Mr. CAWLEY. I understand it is particularly important, both in the magazine and the newspaper industries

Senator CARLSON. Mr. Chairman, I have a letter here from Senator Karl E. Mundt in regard to this particular phase of it with a suggested amendment that I would like to have made a part of the record, following Mr. Cawley's statement.

The CHAIRMAN. It will be entered.

(The letter referred to is as follows:)

UNITED STATES SENATE,
Washington, D. C., April 21, 1955.

Senator FRANK CARLSON,
Senate Office Building, Washington, D. C.

DEAR FRANK: You will recall our earlier exchanges of correspondence with regard to the problem confronting many newspapers in my State as they desire to make certain that they retain the right to credit prepaid subscriptions against taxes for the years on which the subscription money is actually earned.

Your Finance Committee will soon have before it recommendations for the Treasury Department to correct the so-called "blooper." These newspaper publishers fear that in taking the needed corrective steps something might be done to destroy the aforementioned appropriate accounting practices insofar as they are concerned.

I asked one of my newspaper friends to have his counsel prepare some proposed language which might be incorporated in the bill by the Senate Finance Committee at an appropriate place if no one method is evolved for protecting the position of the newspapers.

I am happy to enclose herewith this proposed possible language which was prepared by counsel of a newspaper friend of mine at my suggestion.

I hope that you will offer it—or some amended form of it—to the Senate legislation should necessity arise.

With best wishes and kindest personal regards, I am

Cordially yours,

KARL E. MUNDT, *United States Senator.*

PREPAID SUBSCRIPTIONS

(a) A taxpayer who receives prepaid subscriptions on publications and who keeps his books and files returns on an accrual basis may, without the consent of the Secretary, or his delegate, make an election for his first taxable year which begins after December 31, 1953, to include income from such prepaid subscriptions in gross income for the taxable year in which received and for each of the succeeding taxable years, to the extent proper under the accrual method of accounting.

(b) A taxpayer who receives such prepaid subscriptions may, with the consent of the Secretary, or his delegate, make an election under this section at any time.

(c) If a return has already been made which is in compliance with this section, same shall be fully effective hereunder.

Senator CARLSON. And then, I have a copy of a letter that was written by Cranston Williams of the American Newspaper Publishers Association to Jere Cooper, chairman of the House Ways and Means Committee to follow that.

The CHAIRMAN. That may be done.

(The letter referred to is as follows:)

AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION,
New York, N. Y., March 22, 1955.

HON. JERE COOPER,
Chairman, House Ways and Means Committee,
House Office Building, Washington, D. C.

DEAR MR. CHAIRMAN: The American Newspaper Publishers Association is addressing you as chairman of the House Ways and Means Committee in connection with consideration by your committee of bills H. R. 4725 and H. R. 4726 to repeal section 452 of the Internal Revenue Code of 1954 dealing with prepaid subscription income. We respectfully ask that our views be made a part of the printed record of the hearings.

The American Newspaper Publishers Association is a trade association comprising approximately 800 daily newspapers with more than 90 percent of total United States daily newspaper circulation.

Newspapers are normally paid in advance for many copies to be issued and delivered at future dates. Subscriptions may be for a period of months, a year, or a period of years. Regardless of the period covered by the subscription, payment is made in advance.

Under the accrual method of accounting, income is not determined on the basis of receipts, nor are expenses determined on the basis of amounts paid out. The purpose of the accrual method of accounting is to include in income not only items of receipt but also items representing the right to receive income. In respect to expenses, the accrual basis reflects not only amounts actually paid out, but also amounts owing.

Prior to 1938, some newspapers reported as taxable income in the year of receipt all subscription moneys received, regardless of the period or periods covered by the subscriptions. In other cases, newspapers allocated income received over the period of the subscription and reported income on that basis.

The Bureau of Internal Revenue in 1938 issued G. C. M. 20021 which held that regardless of the method of accounting in use by the publishers, subscription income was taxable in the year received and could not be allocated over the period of the subscription. Issuance of this order aroused criticism, and in 1940 the Bureau of Internal Revenue issued I. T. 3369 in which it was held that both methods of accounting for subscription income would be recognized. The effect of this ruling was that newspapers which had previously adopted the method of reporting subscription income as earned could continue on that basis. Newspapers which had not previously adopted the method of reporting income as earned were required to continue to report income on the basis of receipts. No permission would be granted newspapers to change from reporting income as received to reporting income as earned.

The inequities of this interpretation are apparent. Two taxpayers engaged in identical businesses and keeping their books in the same way, could be required to report income on two different bases, because one taxpayer had prior to 1938 adopted the method of reporting income as earned, while the other had adopted the method of reporting income as received.

Congress included in the Internal Revenue Code of 1954 section 452 (a), which provides as follows:

"In the case of any prepaid income to which this section applies, if the liability described in subsection (e) (2) is (at the time the income is received) to end before the first day of the sixth taxable year in which such income is received, then such income shall be included in gross income for the taxable year in which received, and for each of the 5 succeeding taxable years, to the extent proper under the method of accounting used under section 446 in computing taxable income for such year."

The intent of Congress was to put competing businesses on the same basis insofar as determining taxable income is concerned, and to eliminate the inequities created by rulings of the Commissioner of Internal Revenue.

The 1954 revenue law granted taxpayers the privilege of reporting income according to their method of accounting. This is also in accord with section

446 (a) of the Internal Revenue Code, which provides that taxable income shall be computed in accordance with the method of accounting.

Since section 452 of the Revenue Code of 1954 corrected an inequitable situation, under rulings of the Internal Revenue Commissioner, there would seem to be no justification for repeal of the section. As a matter of fact, enactment of this provision was long overdue.

In the case of Beacon Publishing Co. of Wichita, Kans., the United States Circuit Court of Appeals for the Tenth Circuit held the Commissioner's interpretation of the 1939 code was incorrect. In the Beacon Publishing Co. case, decided January 3, 1955, the court held the taxpayer was entitled, under its method of accounting, to report subscription income as earned, even though it had not adopted that basis prior to the issuance of I. T. 3369. The Commissioner denied Beacon Publishing Co. the right to compute its income on the basis of earnings, rather than on the basis of receipts. The company changed without permission of the Commissioner. In its opinion the court held:

"The Commissioner urges that since the taxpayer had for years prior to 1943 and 1944 carried these items on its books as cash items, it cannot change its system of accounting without the consent of the Commissioner. * * * The taxpayer, however, did not seek to change its accounting system. It did no more than apply the method adopted and in use to clearly reflect its income. This the taxpayer had a right to do and the Commissioner had the right to require it."

What Congress wrote into the 1954 Internal Revenue Code and what is now proposed to repeal is no different than the Tenth Circuit Court of Appeals' interpretation of the 1939 code. Repeal of section 452 will not change the situation if the Tenth Circuit Court's interpretation of the 1939 code is correct but much tax litigation can be avoided if Congress leaves section 452 intact or recognizes in any change the fairness of the present law as related to prepaid subscriptions.

The ANPA believes that action of the Congress in 1954 in bringing tax accounting nearer into conformity with accepted business accounting principles is fundamentally sound, and in the public interest. This association favors retention of section 452 in the Internal Revenue Code of 1954 as related to prepaid subscriptions of newspapers.

Sincerely yours,

CRANSTON WILLIAMS, *General Manager.*

Senator CARLSON. Thank you, Mr. Chairman.

The CHAIRMAN. J. Henry Landman, of New York, was scheduled to appear today. However he was unable to be present and in lieu thereof I submit his statement for the record.

LET US NOT ABANDON CORRECT TAX REPORTING—SECTIONS 452 AND 462 OF THE 1954 INTERNAL REVENUE CODE MUST NOT BE REPEALED—STATEMENT BY J. HENRY LANDMAN, PH. D., J. D., J. S. D., NEW YORK TAX LAWYER, AND PROFESSOR OF TAX LAW AT THE NEW YORK LAW SCHOOL

Section 452 of the Internal Revenue Code of 1954 purports to rectify the error of including in a taxpayer's current taxable income prepaid receipts, such as prepaid rent, though they are for services or goods to be provided in the future. This is effected in accordance with recognized accounting principles by permitting the recipient to defer the inclusion in taxable income of these amounts until earned. As a necessary concomitant, the related section 462 permits an accrual taxpayer to treat deductible expenses in his trade or business attributable to concurrent income on a reasonably accurate estimated basis, rather than to take these deductions when these expenses are actually incurred with the consequence that the taxpayer's annual earnings are distorted.

At long last, the accounting profession prevailed on Congress to enact legislation that predicates tax reporting on sound accounting and therefore on more realistic concepts.

These new sections of our tax law were not hastily legislated. The American Institute of Accountants has been agitating for many years for such conformance of tax with business bookkeeping. Yet the Treasury now recommends the immediate retroactive repeal of both sections because they will give rise to an estimated $500 million loss of revenue in the current year thus effecting a greater imbalance of the Federal budget by this relatively minor amount than otherwise. Actually, this loss to the Treasury is not a reality because it will be recovered from taxpayers in subsequent years in the form of additional taxes.

Thus this long-fought-for remedial legislation less than 1 year old without any reliable experience and history has its perpetuation threatened because of misunderstandings, exaggerations, and political animosity.

On March 1, 1955, the Senate Finance Committee eliminated from the Tax Rate Extension Act the Democratic-sponsored $20-a-person income tax cut. By contrast, sections 452 and 462 have been wrongfully made to appear like unwarranted windfalls for business.

In truth, these sections merely fix the years when income is to be reported and decide that its applicable expenses are to be deducted concurrently. No expense is deductible now that would not have been previously deducted, and, contrary to the views of the unsophisticated, no item of expense is deducted twice. There are neither loopholes nor windfalls in this legislation. It was carefully and deliberately drafted as evidenced by the elaborate statutory language, the relevant copious committee reports, and the already promulgated Treasury regulations after many years of agitation in behalf of the more accurate reserve method of accounting.

Is it not just to tax only that income that remains in a given year after deducting related reasonably accurate estimated expenses? Is it not correct to tax future income only when earned after having offset concurrent expenses? While two deductions are effected but only in the year of election for the same item of expense, they are proper because they are attributable to two different items of income. Under the prior law, a product service guarantee was not deductible until exactly determined by actual performance. It would have been more realistic if the estimated service costs arising out of this guaranty would have been deducted when the original sale of the product was accrued. Hence it is reasonable to allow an expense deduction, or forever abandon it, which was not allowed in earlier years as concurrent offsetting expenses to gross income. Obviously too, a reasonably accurate estimate of expenses as a deduction against present income is also in order.

Our country has already had adequate experience with one large estimated contingency expense; that is the bad debt. Its history has proven that this reserve procedure is not susceptible of abuse or of undue litigation because actual taxpayer experience with this deductible item has proven to be an effective arbiter in the occasional dispute between taxpayer and Treasury at the time of audit at a later date.

On March 22, 1955, the House Ways and Means Committee ordered the repealer of sections 452 and 462—H. R. 4725. An amendment to it provides that interest and penalties arising from the repeal would be excused. An extension of time until September 15, 1955, is granted to pay additional taxes and to make other adjustments such as contingent executive salaries based on company earnings, and pension and profitsharing contributions. Presumably an honest attempt is being made to put taxpayers in status quo ante, but that is not altogether possible. The financial statements of many taxpayers have already been publicized. Those who have entered into contracts which enabled them to receive accumulated income which they in good faith expected to defer for tax purposes are now penalized by being obliged to report at once the bunched up income at consequential advanced rates.

Our Government must recognize that in a self-assessing system of taxation like ours the mutual good faith of the public and the Government is the sine qua non for its success. Our citizens are reputed to be the greatest tax grumblers but nevertheless the most honest taxpayers on earth. Morally they are entitled to good faith on the part of their Government. Let us hope the day never comes when our citizenry loses faith in its Government. The repeal of equitable tax laws because of an unanticipated discrepancy in estimates of revenue losses stemming from such legislation, which at best are approximations, and which losses regardless of the amounts will be recovered through additional revenue in subsequent years, is too big a price to pay for the possible loss of public good will.

The repeal of sections 452 and 462 is more than immoral. It is my considered opinion that such conduct on the part of Congress is illegal and unconstitutional. Retroactive legislation which impairs the vested and substantive rights of citizens in contradistinction to explanatory statutes, is invalid and unconstitutional in that it denies due process of law. Taxpayers do have vested and substantive rights in the present sections 452 and 462. They acted in good faith when they elected these sections. As a matter of fact, those who served in a fiduciary capacity such as the managements of corporations would have been derelict in their duties and would have been held accountable if they had not elected to effect tax economy by making such elections. Moreover, they would have had to make such election for "all estimated expenses attributable to [their] trade or business"

under section 462 (c) (2). Hence any imputation that some taxpayers were abusing this section is without foundation in sound law and in good accounting.

The due process of law clause of the fifth amendment to the United States Constitution is not a limitation upon the taxing power conferred upon Congress, unless the taxing statute is so arbitrary as to compel the conclusion that it was not the exertion of taxation, but the confiscation of property or is so wanting in substance as to produce such a gross and patent inequality as inevitably to lead to the same conclusion.[1] Consistent with this concept, retroactive tax statutes for relatively short periods so as to include profits from transactions consummated while the statutes were in process of enactment, or within so much of the calendar years as preceded enactment, are not in violation of the due process of law clause of the fifth amendment.[2] Factually when taxpayers elected sections 452 and 462 they had no cause to suspect that these laws were ever going to be repealed. It is already the uncontroverted rule as to taxes other than income tax, that if at the time a citizen enters into a transaction the profit therefrom is not taxable and he has no reason to believe or expect a tax in the future will be imposed by reason of it, a valid tax thereon cannot be laid by a subsequent statute.[3] In conclusion, it is my considered opinion that in the income-tax field of sections 452 and 462 where taxpayers had to elect those sections and did so in good faith without anticipation of their repeal and cannot be put in status quo ante, which are the facts in the situation before us, their repeal would be invalid and unconstitutional.

There is no compromising with justice. Taxpayers are entitled to what is due to them morally and legally under sections 452 and 462.

The CHAIRMAN. Harman E. Snoke, executive vice president, Manufacturers Association of Bridgeport.

STATEMENT OF HARMAN E. SNOKE, EXECUTIVE VICE PRESIDENT, MANUFACTURERS ASSOCIATION OF BRIDGEPORT, CONN.

Mr. SNOKE. My name is Harman E. Snoke. I am executive vice president of the Manufacturers Association of the City of Bridgeport, Conn., Inc., 211 State Street, Bridgeport 3, Conn., which is an association of some 110 manufacturers established in the year 1900.

This association has a committee on taxation which has been concerned primarily with matters of Federal and State taxation. The committee is listed on exhibit A.

This committee has pursued taxation developments affecting industry for the past 4 years, giving particular considertion to changes in the tax laws finally embodied in the Internal Revenue Code of 1954.

When the proposed regulations implementing sections 452 and 462 concerning prepaid income and reserves for estimated expenses were promulgated earlier this year, the committee gave careful study to these two sections and the proposed regulations, submitting its observations to the Honorable T. Coleman Andrews, Commissioner of Internal Revenue, on February 21.

With the introduction of the House bill 4725 which would repeal sections 452 and 462 of the Internal Revenue Code of 1954, the committee made a study of the effect such retroactive repeal would have on specific businesses.

As a result of this study, this committee on taxation has asked that I appear in opposition to the enactment of this legislation.

It is the firm belief of this committee that:

1. Retroactive repeal works an undue hardship on many businesses which adopted in good faith the accounting practices prescribed;

[1] *Brushaber* v. *Union Pacific R. R. Co.* (1916) (240 U. S. 1, 36 S. Ct. 236, 3 A. F. T. R. 2920).
[2] *United States* v. *Hudson* (1937) (299 U. S. 498, 18 A. F. T. R. 628, reversing 82 Ct. Cl. 15, 12 F. Supp. 620, 16 A. F. T. R. 1207, 13 F. Supp. 640, 17 A. F. T. R. 814).
[3] *Nichols* v. *Coolidge* (1927) (274 U. S. 531, 71 L. Ed. 1184, 52 A. L. R. 1081, 47 S. Ct. 710, 6 A. F. T. R. 6758); *Untermeyer* v. *Anderson* (1928) (276 U. S. 440, 72 L. Ed. 645, 48 S. Ct. 353, 6 A. F. T. R. 7789); *Milliken* v. *United States* (1931) (283 U. S. 15, 75 L. Ed. 809, 51 S. Ct. 324, Ct. D. 320, C. B. June 1931, p. 472, 9 A. F. T. R. 993.

2. Retroactive repeal could establish a precedent for later retroactive changes in exemptions and other provisions of personal income and other forms of taxation;

3. Retroactive repeal would involve serious legal, ethical, and moral considerations as set forth in a supporting statement by committee member Ralph W. Wilson, which I am asked be entered as exhibit B.

4. Regulations can be written to adequately cover the intent of Congress to bring taxation accounting into line with established accounting practices.

(The exhibit referred to appears at the end of the oral testimony.)

Mr. SNOKE. Mr. Wilson is here on my left.

The CHAIRMAN. There is no objection.

Mr. SNOKE. Retroactive repeal of the provisions of sections 452 and 462 works an undue hardship on corporations which have pursued the normal processes of closing their books, paying dividends based on the use of such sections, issuing their annual reports to stockholders, and filing their tax return on March 15.

Further, it occasions considerable confusion and embarrassment to corporate management, stockholders, financial institutions, and regulatory bodies.

The effect of some of the problems which the proposed retroactive repeal causes are illustrated briefly in actual situations provided by members of this tax committee.

The first example pertains to a manufacturer of business machines which employs approximately 1,000 persons in its manufacturing plant in Bridgeport.

The annual report of this company discloses that under current liabilities it has set aside a reserve of some $600,000 for deferred (prepaid) income as a result of maintenance contracts on the business machines it produces. Such amount represents billing to customers for which no services have been rendered as yet.

This $600,000 of prepaid income is actually unearned income.

Under the 1939 Revenue Code this prepaid income was taxable although it is definitely not earned income.

Obviously such treatment of prepaid income violates generally accepted accounting principles.

Should section 452 be repealed retroactively, this company would have to pay tax on this deferred income even though unearned.

At 52 percent, the tax due would be $300,000.

The effect of this payment would be to reduce immediately the available working capital of this company.

For a number of years this company followed consistently the practice of keeping its prepaid income accounts on an accrual basis and allocating income to the months in which it was earned.

However, some years ago, the Internal Revenue auditors insisted that under the old code, such income could not be deferred, but that the entire amount of the maintenance contract billing must be included in the year of billing regardless of the fact that it was unearned income.

The company, therefore, could not follow either the cash basis, or accrual basis which is accepted as the best accounting practice, in determining taxable income. The Internal Revenue Department forced this company to keep separate sets of books, on a hybrid basis.

The 1954 Code, by contrast, permitted the handling of this deferred income on a true accrual basis.

Should H. R. 4725 be passed, this company must pay additional taxes by merely making a naked-book entry. It would also experience some of the other difficulties which will be cited in the examples which follow.

The second example pertains to a manufacturer of building materials which employs about 175 persons in its local plant and has a selling force of over 1,000 persons in other parts of the country.

Earnings and balance sheets of this company have already been released to the public and stockholders.

This company had set up and reported reserves for estimated expenses of approximately $120,000.

The CHAIRMAN. Exactly what kind of expenses were those?

Mr. SNOKE. I do not know. They were the ones provided strictly for vacations and some for other things. I cannot tell you the exact amount of these. They were those provided, though, in the terms of the committee hearings, I know that, and joint committee recommendations.

Should H. R. 4725 be enacted, it would result in the company having to report higher profits and resulting higher income taxes.

Its underestimate of taxes at 52 percent would be some $60,000. As a result of this, there would be an underpayment as of March 15 of $30,000 on which interest charges would be running.

As all the books had been closed for 1954, retroactive repeal of section 462 would create a lot of confusion within the organization because of the required accounting and fiscal changes.

The company would incur additional expenses for outside public accountants to recompute the results and to prepare a corrected financial statement.

This company has a profit-sharing plan and contributions are based on the current annual profits. In 1954 profits were computed in accordance with the 1954 Revenue Code.

Should H. R. 4725 be enacted it would be necessary to recompute the profits and to pay an additional amount to the trustees of the profit-sharing plan because the books would show an increase in profits in 1954. This problem is a very serious one for many companies both large and small which have profit-sharing plans.

One of the most serious aspects of the retroactive repeal of section 462 would be that it would be necessary to prepare supplementary statements for stockholders. Should stockholders receive two reports regarding a company's profits, they might be very much concerned and might feel that they do not know how much money the company had made.

In the case of this company 1.5 percent of the stockholders own 1,000 shares or more. Most of the stockholders own only a few shares, including a number of employees of the company.

The effect of issuing supplementary financial statements might tend to shake the confidence of the stockholders in this company.

Example 3: As the third example, I would like to cite the case of a manufacturer employing approximately 3,000 persons. As indicated in its annual report, this company established accrual accounts "for vacation costs and other expenses at the year end, as permitted under the Internal Revenue Code of 1954," of some $850,000.

Of this amount, $775,000 was reserved for accrued vacations which was a proper accounting charge attributable to the year 1954. The remainder represents minor items for estimated cash discounts, accruable State taxes and estimated returns and allowances computation of which was based on experience.

The CHAIRMAN. Are accruable State taxes deductible regardless of these two sections?

Mr. SNOKE. Yes; I guess they would be.

The CHAIRMAN. You listed them in there.

Mr. SNOKE. They were in the accounts. I was taking what the Treasury had, and it was in the report.

Should H. R. 4725 be enacted, repealing section 462 retroactively, the company would be immediately liable for payment of some $425,000 and the profit and loss picture of the company already distributed to stockholders would be altered materially.

The stock of this company is widely held by the public, there being no dominant stockholders. Despite explanations in supplementary reports, the confidence of stockholders in this very sound and progressive company might be seriously shaken.

CONCLUSION

Manufacturers, especially the small ones, have been troubled by the necessity of keeping extra sets of records resulting from the inconsistency between tax accounting requirements and generally accepted accounting principles.

Sections 452 and 462 in the Internal Revenue Code of 1954 are good examples of the efforts made by the joint committee to conform tax accounting to recognized accounting practices.

Retroactive repeal of these sections would work inestimable financial hardship not only on the companies but their stockholders, many of which are employees.

Public confidence in the financial status of the companies in which millions of individuals hold investments would be definitely shaken.

The Manufacturers Association of Bridgeport and its committee on taxation respectfully urge that H. R. 4725 be reported unfavorably and the Secretary of the Treasury requested to prescribe regulations which will implement the original intent of Congress in its adoption of the 1954 Tax Code. To facilitate the writing of regulations Congress may wish to enact clarifying amendments effective in 1955.

In the opinion of this committee, retroactive repeal would result in an adverse effect on business, our Nation and its citizens which would far outweigh any temporary reduction in income which the Government would sustain.

Finally, it is hoped that your committee will decide to safeguard the confidence of the investing public and employees of companies which acted in good faith in reliance on congressional action embodied in the Internal Revenue Code of 1954.

The CHAIRMAN. Thank you very much, sir.

Any questions?

Senator CARLSON. No questions.

The CHAIRMAN. Thank you very much.

Mr. SNOKE. Thank you, sir.

(The exhibits referred to follow:)

EXHIBIT A

COMMITTEE ON TAXATION, 1955, MANUFACTURERS ASSOCIATION OF THE CITY OF BRIDGEPORT, CONN.

Chairman: Carroll F. Lewis, manager, tax division, Remington Arms Co., Inc., Bridgeport 2, Conn.
Vice Chairman: Joseph P. McNamara, assistant secretary and counsel, Bridgeport Brass Co., Bridgeport 2, Conn.
Rudolph F. Bannow, president, Bridgeport Machines, Inc., 500 Lindley Street, Bridgeport, Conn.
Herbert A. George, secretary and treasurer, Connecticut Railway & Lighting Co., 177 State Street, Bridgeport 3, Conn.
George H. Maslen, controller, American Chain & Cable Co., Inc., Bridgeport 2, Conn.
Norman K. Parsells, Marsh, Day & Calhoun, 886 Main Street, Bridgeport, Conn.
Earl B. Snell, treasurer, the Bridgeport Gas Light Co., 815 Main Street, Bridgeport, Conn.
Harman E. Snoke, executive vice president, Manufacturers Association, 211 State Street, Bridgeport 3, Conn.
Roger Wakeman, assistant to the controller, the Bullard Co., Bridgeport 2, Conn.
Albert J. Wieland, treasurer, Tilo Roofing Co., Inc., 347 Longbrook Avenue, Stratford, Conn.
Ralph W. Wilson, tax attorney, Dictaphone Corp., 375 Howard Avenue, Bridgeport 5, Conn.
Ernest M. Winterburn, office manager, the Singer Manufacturing Co., 915 Pembroke Street, Bridgeport 8, Conn.

EXHIBIT B

STATEMENT OF RALPH W. WILSON IN AMPLIFICATION OF STATEMENT BY THE MANUFACTURERS ASSOCIATION OF THE CITY OF BRIDGEPORT, CONN., INC., WITH RESPECT TO SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

Mr. Chairman and gentlemen of the committee, my name is Ralph W. Wilson, the attorney-manager of the tax department of Dictaphone Corp., and a member of the committee on taxation of the Manufacturers Association of Bridgeport, Conn.

I am not unaware of the highly commendable efforts of the chairman of this committee and the members of it in their endeavors to balance the budget and to provide the Government with adequate revenues with which to do it.

These endeavors are praiseworthy and desirable and every American ought to be willing to do everything within his individual power to help in effecting a solution.

This problem is one of finance and well within the sphere of the Treasury Department and doubtless, when faced with what appeared to be a substantial loss of revenue, caused the Honorable Secretary of the Treasury to appear before the House Ways and Means Committee and request a repeal of sections 452 and 462 of the Internal Revenue Code of 1954.

But it was hardly a year ago that the Congress of the United States, in its wisdom, and after lengthy hearings and deliberations enacted the Internal Revenue Code of 1954. Its avowed purpose, in part, was to correct certain inequities and to bring within the law sound principles of accounting, particularly with respect to the accrual basis method of accounting.

The insertion of sections 452 and 462 in the Internal Revenue Code made it possible for business to allocate income of an accrual basis taxpayer to the period when it was earned or the expense incurred. By spelling out these provisions into the law it also meant that in judicial decisions rendered by the courts, the judges would be able to recognize sound accounting principles in the rendition of their judgments. There would be little room for error.

Enactment of this legislation was a long step in the reconciliation of conflicting legal decisions with actual and practical accounting methods. Spelling out the procedure in the code would make it possible for the judiciary to decide cases in conformity with sound accounting procedures and thus eliminate legal decisions that recognize neither the cash nor the accrual basis of accounting, but when rendered were hybrid in nature.

Such was the law of the land on December 31, 1954. In reliance upon this duly and constitutionally enacted Federal legislation, American business, commerce, and industry acted as it had a perfect and legal right to so act in the preparation of millions of business reports and documents, all of which are prepared in accordance with the solemn law of the land, or at least so they believed.

However, it now appears that the Treasury Department is of the opinion that there might be a serious loss of revenue if these provisions are allowed to remain in the law. The Treasury now comes to the Congress to change the law, not as to its effects on the calendar year 1955, but requesting that it be made retoactive to January 1, 1954.

It matters not that the code was in fact the law of the land in 1954.

It matters not that Americans have the moral and legal right to rely in good faith on the enactment of legislation by its duly elected legislative body.

It matters not that it will cost American business millions of dollars to correct data in its submitted reports.

It matters not that the right of American business to rely upon duly enacted Federal legislation is brushed aside.

The Government believes that it has need for the money and now asks the Congress to change the law in its favor. Is there to be one law for the people and another law for the Government, or is the Government to be bound by the same law as the people?

The legal aspects of retroactivity to January 1, 1954, of certain sections of the code is not in question here, that is a matter solely for the judiciary. The moral aspects are a matter for the people.

It is well recognized that the power to tax is the power to destroy and the Congress, in a national emergency, has almost limitless powers. But no national emergency exists at this time, and apparently, the avowed purpose of this bill is concerned solely with an anticipated loss of tax revenue.

Is this event new in contemporary fiscal history of the United States?

If the law can be changed retroactively for the business concerns, it can also be changed for individuals.

If Congress were to repeal certain provisions effecting personal exemptions retroactively to an earlier year, Washington would be justly stormed with public indignation.

To enact this bill retroactive to January 1, 1954, at this time would be to establish a dangerous precedent, would shake the confidence of American business in its reliance upon duly enacted Federal legislation, would weaken the faith of the American people in its belief in its established institutions, would create an atmosphere of perpetual uncertainty, and definitely would not be in the public interest.

It is my personal belief that in life there are some things more precious than money and the greatest of these is honor and our entire Government is based upon a government by honorable and just laws and freedom under the law.

But what can a man believe?

Do we have the right to believe our laws?

Do we have a right to act in accordance with them? Or do we wake up to the fact that what we believed and how we acted in good faith just is not so?

If this repeal is enacted retroactively to January 1, 1954, is it not a serious breach of faith with American businessmen?

Is it not a repudiation of all he had a legal and moral right to believe?

Why is repeal, January 1, 1954, necessary? At the end of 1954 when business closed its books and adjusted its records, certain prepayments, deferrals, etc., were taken into consideration. It is true that as a result of this situation income and governmental revenues may be somewhat decreased. But a situation of this sort would frequently occur in any technical adjustment of almost any tax law. It is a one-time benefit at most.

If modifications are made in sections 452 and 462 they should not be made applicable prior to January 1, 1955. By doing this you would not in any way violate the confidence of the American people nor disturb 1954 reports.

The calendar year 1955 is practically one-half over at this time and if modification were to take effect as at January 1, 1955, the reserves created at the end of 1954 would stand and 1955 would provide an increase in income and alleviate any losses to the Government because of sections 452 and 462 being in effect in 1954. The equilibrium would not be upset, and business would be spared a tremendous amount of work necessary to change 1954 fiscal data.

Retroactive repeal would, in effect, invalidate 1954 tax returns already filed and published annual reports to stockholders, financial institutions and regulatory bodies.

Limitation of modifications of sections 452 and 462 to January 1, 1955, and thereafter would validate these prime records of American business.

Now to get down to cases. One short example will illustrate the deficiencies of the Internal Revenue Code of 1939 and how the inequity was adequately corrected by sections 452 and 462.

The corporation by whom I am employed is not a large one but is a very successful manufacturer of business and sound recording machines.

Since these machines are electronic in nature, we make available to our customers a service contract. By this I mean that we agree to service our customers machines monthly for a 1-year period for a stipulated price. This service contract is on a 1-year basis beginning on any day of the year and ending 1 year later. It is never possible to complete such a contract in less than a 12-month period.

However, under "the claim of right doctrine" the naked charging of an account receivable and crediting deferred maintenance income resulted in the imposition of an immediate tax liability of 52 percent.

To illustrate this transaction: if we billed customers for $2 million worth of these contracts and credited deferred maintenance income, without collecting a single penny of revenue, we immediately assume a tax obligation of more than $1 million. In many instances payment of this tax obligation would be required before we had collected a single penny of revenue of this nature from a customer.

Is it fair and just that we are immediately liable for $1 million in income taxes on contracts that we cannot possibly perform in less than 1 year and on which collections from customers will be spread over a period of time and may even in certain events be canceled?

Under sections 452 and 462 we are allowed to book a reserve for prepaid income and to pick up the income (one-twelfth each month) as it is actually earned and treat costs in the same pro rata basis throughout the year.

The CHAIRMAN. We will meet tomorrow morning at 10 o'clock in executive session.

(By direction of the chairman, the following is made a part of the record:)

MAY 9, 1955.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR BYRD: Reference is made to a bill now pending before your committee, namely, H. R. 4725, a bill to repeal, effective with taxable years beginning after December 31, 1953, and ending after the date of enactment of the 1954 code, the provisions of the code relating to the allocation of prepaid income (sec. 452) and the allowance of reserves for estimated expenses (sec. 462).

In this connection, I wish to advise you that if this bill is enacted, it will work a great hardship on many manufacturing firms in Connecticut who have closed their books, filed their tax returns and issued their financial statements on the basis of these sections of the 1954 code.

I very strongly feel that the Federal Government ought to acknowledge its obligation to these taxpayers' who acted in good faith. Furthermore, the proposed retroactive repealer is not in accordance with sound business practices. These two provisions were included in the 1954 code among other accounting changes with the purpose of conforming tax accounting with, generally, principles of business accounting.

At the time the Congress was considering the 1954 code, the revenue loss estimate attributed to these accounting changes was $15 million. Now, however, Treasury Department officials claim they made a mistake in their estimates and urge Congress that these two provisions be repealed retroactively to their orginal effective dates. I reiterate that I can't see why taxpayers who acted in good faith should be penalized by the self-admitted mistakes of the United States Treasury Department.

If you and your committee decides to act favorably on H. R. 4725, I earnestly suggest that the bill be amended to specifically exclude from its operations reserves for vacation and holiday pay. Many industrial vacation plans provide that an employee shall be entitled to vacation pay if he has been employed for a stated period, immediately prior to the vacation period. Although the reserves for this liability can be estimated with considerable accuracy on the basis of past experience of the individual employer, in many cases the Internal Revenue Bureau has

refused to allow a deduction for such reserves on the basis that the liability to a particular employee is not fixed and certain until he has worked for the full year preceding the vacation period.

The variance between the requirements of the Internal Revenue Bureau with respect to the deductibility of this item and the universally accepted method of accruing reserves for many Connecticut industrial firms and their employees.

Thanking you for your consideration of this matter, I am

Sincerely yours,

JAMES T. PATTERSON,
Member of Congress.

THE BORDEN CO.,
New York, N. Y., May 12, 1955.

CLERK, SENATE FINANCE COMMITTEE,
Washington, D. C.

DEAR SIR: We are writing you in accordance with the recent announcement in the press whereby the Senate Finance Committee invited interested parties to file written statements regarding the proposed retroactive repeal of section 462 of the Internal Revenue Code of 1954. It is respectfully requested that the following views and comments be considered by the committee.

Undoubtedly many statements pro and con will be received on the subject. Our position is, of course, that section 462 should be amended, not repealed retroactively.

If section 462 is presently so worded that it will permit deductions from taxable income that were never intended by Congress, the section should be amended. As we understand it, the one big objection to section 462 is that it permits those taxpayers who have followed the letter of the law, rather than the spirit and intent, to effectively postpone indefinitely all or a part of their 1954 tax. Naturally, the Government is concerned about this unintended loss of revenue, as are the bulk of taxpayers who will eventually, if the section is not corrected, be called upon to make up the loss through higher taxes. The big problem then is to recoup the lost revenue, which can be accomplished in the 1955 tax year.

We recommend that section 462, I. R. C. of 1954 be retained for the calendar year 1954 and for initial fiscal years beginning after December 31, 1953, and ending after August 16, 1954. Section 462 should be amended to provide that for later taxable years, reserves will be allowed only for specific items of estimated expense, principally those enumerated in the report of the Committee on Ways and Means accompanying H. R. 8300, and for which no deduction is allowed under any other section of the code. To the extent reserves for estimated expenses other than the so specified reserves have not been liquidated by the end of 1955 (or at the end of a corresponding period for fiscal-year taxpayers) they be required to be taken into income in the 1955 return.

If this amendment is properly drawn, it will have the effect of shifting tax revenue from the 1954-55 fiscal year to the 1955-56 fiscal year.

The retroactive repeal of section 462 of the Internal Revenue Code of 1954 would be extremely unfair to taxpayers who, relying on the section, have already determined their income after Federal income taxes and made business or personal commitments. Reports to the shareholders and creditors have been issued on the basis of the new tax law. Similarly, dividends have been paid in reliance upon the 1954 tax statute. It is our firm conviction that a retroactive repeal of section 462 would result in gross inequity and commercial instability. We are informed by legal counsel that, in the past, Congress has recognized an inequity similar to that which would result from the retroactive repeal of section 462, as a basis for rejecting such legislation. In 1917, the 65th Congress refused to levy additional tax on 1916 income and the reasoning in this regard is clearly stated in the report of the Senate Finance Committee.

A repeal of section 462, Internal Revenue Code of 1954, retroactively effective in respect of completed taxable years governed by the code of 1954, on or after the date prescribed for filing income tax returns for such completed taxable year, could give rise to extensive constitutional litigation which might very well result in the invalidation of the repeal at some later date. It is not our intention to attempt to describe precedent for the above statement for we are certain that this will be adequately covered in statements prepared by the legal profession.

In summation, therefore, it is our recommendation that:

1. Section 462 should be amended to recoup the revenue unintentionally lost in the 1954-55 fiscal year.

2. Section 462 should not be repealed retroactively since reports to stockholders, creditors, etc., have relied on the section as contained in the present statute.

3. Section 462 should not be repealed retroactively because of litigation it would engender.

Respectfully submitted,

T. O. HOEMAN, *General Controller.*

RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION,
Washington, D. C., May 12, 1955.

Re H. R. 4725.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington 25, D. C.

DEAR SENATOR BYRD: This letter is respectfully submitted on behalf of the Radio-Electronics-Television Manufacturers Association, a national organization comprising approximately 383 companies who manufacture television sets, radio sets, other electronic end products and their component parts. We oppose the repeal of sections 452 and 562 of the Internal Revenue Code as proposed in H. R. 4725.

In our opinion, these sections embody principles which are unquestionably sound and fair. Their objective is to bring tax accounting and business accounting into conformity. Their enactment removed inequities that have been suffered in the past. Certainly the accomplishment of this objective is in the public interest. The revenue and administrative difficulties that have been mentioned in the statements of the Secretary of the Treasury, as reported in the press, do not justify abandonment of these sound principles. It is our view that these revenue and administrative problems can be handled without resort to such an extreme measure as outright repeal.

The requests for repeal of section 462 are based on the revenue problem involved and the possibility that the section will be availed of for expenditures which were never intended to be included. We do not believe that the possibility of abuse of the section by taxpayers constitutes a sufficient reason for its repeal. Every section of the code can be abused. This is a matter of administration. We would favor all reasonable safeguards in the public interest against abuse of this section and feel that such safeguards can be written into the statute by way of amendment.

Three methods have been suggested for limiting the scope of the sections and thus protect the public against abuse. The first is to give the Secretary of the Treasury the authority to specify by regulation the type of item for which a deductible reserve may be established. The second is to specify in the statute the items of estimated expense permitted by the section. The third is to specify in the statute the items of estimated expense not permitted by the section.

We have no particular quarrel with any of these suggestions and feel that any one could be so written as to provide the necessary safeguards. Our preference would be to recite in the statute the items of expense that are to be covered by the section. For the present we propose that these items be restricted to the ones listed as examples in section 1.462-5 (c) (6) of the tentative regulations issued by the Treasury. These include cash discounts, product warranties, sales returns and allowances, freight allowances, quantity discounts, vacation pay, and self-insurance by common carriers for liability for cargo damages.

An unwelcome revenue effect in a single year is no justification for abandoning a sound principle and receding to an erroneous principle. Progress would never be made if temporary side effects of needed reforms were allowed to prevent the adoption of such reforms. Rather, the revenue impact should be softened in some reasonable way. Suggestions have been made to the committee to do this by spreading the revenue loss over a period of time, such as 3, 5, or 10 years. Such suggestions seem to be a feasible and practicable way to minimize the impact of the revenue loss in the year of transition. The exact length of the stretchout period should be chosen by the committee in the light of what the committee decides as the preferred method of controlling the scope of the section, since these controls will greatly affect the estimated revenue impact of the section. It is thus impossible for us either to estimate the revenue impact or to designate the length of the stretchout period. We feel, however, that a 10-year stretchout is too long because it would tend to defeat the purpose of the section. Many taxpayers, particularly small businesses, might prefer to forego use of the section

rather than assume an additional accounting burden of that duration. This is a matter of importance to our industry because approximately 75 percent of the companies in our association have less than 500 employees and fall into the official small business classification.

The television set manufacturing segment of our industry offers an apt illustration of the wisdom and soundness of section 462. There are 44 companies in our association which are engaged in the sale of television sets, and 34 companies engaged in selling tubes. The facts I am about to outline are generally characteristic of all of these companies, and any exceptions are, I believe, scattered and relatively insignificant. For many years these companies have had to make their tax returns and pay taxes on a set of accounts different from the accounts they must maintain for business purposes.

When a television set is sold the customer obtains a warranty against defective material or workmanship for a period of 3 months on the set itself, and 1 year on the picture tube (there are individual variations, but this is the general practice). The set maker is thus under a contractual obligation to incur expenses to carry out his warranty. The tube maker is under a similar obligation. Such companies, being on an accrual accounting basis, accrue this obligation on their books in the year in which the television sets and tubes are sold. Prior to the enactment of section 462 they had not been able to obtain recognition of this accrual for tax purposes, and had to take the tax deduction later when the cash outlays were made. Section 462 permits such companies to obtain tax recognition of these expenses in the year they are entered on the books.

We know of no one, in or out of Government, who takes the position that estimated warranty expense is not a sound and proper tax deduction under the circumstances I have just described. The opinion appears to be unanimous that section 462 as applied to these facts is fair both to the taxpayer and to the Government.

In conclusion, we submit that the product warranty situation offers a compelling illustration of why the Congress should amend rather than repeal section 462.

Respectfully submitted.

GLEN MCDANIEL, *President.*

AIR TRANSPORT ASSOCIATION OF AMERICA,
Washington, D. C., May 12, 1955.

Subject: H. R. 4725.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR MR. CHAIRMAN: The Air Transport Association of America, which is composed of substantially all of the certificated airlines of the United States, wishes to submit its recommendations on H. R. 4725, which is now the subject of public hearings being held by your committee. We urge the committee to modify H. R. 4725 so that it does not operate as an outright repeal of section 462 of the Internal Revenue Code of 1954 but rather amends that section so that it retains the accounting principle which it now embodies but will not result in the loss of revenue now anticipated.

The Civil Aeronautics Board of the United States regulates not only the operating, but also the economic, aspects of air transportation. As part of the latter function the Board has prescribed a uniform system of accounts, and a manual which must be followed by the airlines in keeping those accounts. Under the Civil Aeronautics Act, which created the Civil Aeronautics Board, it is unlawful for any airline to keep any accounts and records other than those prescribed or approved by the Civil Aeronautics Board. The principle on which section 462 was based, i. e., to bring tax accounting into harmony with generally accepted accounting practices, was a long step toward the realization of the goal that an airline's Federal tax returns should be prepared on the same basis as its books of account and records are maintained under Civil Aeronautics Board regulations. A specific example will serve to illustrate this point. Under the present uniform system of accounts prescribed by the Civil Aeronautics Board the airlines are permitted to establish and maintain reserves for the overhaul of aircraft and aircraft engines. Moreover, at the present time the Civil Aeronautics Board has under consideration a revised uniform system of accounts under which the establishment of reserves for such overhauls would be mandatory. Prior to the enactment of section 462, although a substantial number of the airlines maintained such reserves, additions to them were not deductible for income tax purposes.

Thus section 462 brought airline tax accounting into harmony with Civil Aeronautics Board accounting with respect to this item.

It should be clearly recognized that reference is being made only to aircraft and aircraft engine overhauls and that such overhauls are substantially different from repairs and maintenance of aircraft and engines. Overhauls are required, under regulations issued by the Civil Aeronautics Board and enforced by the Civil Aeronautics Administration, to be made periodically after the aircraft or the engine has been in service for a specific number of hours. Overhauls must be performed, as required by the Civil Air Regulations, whether or not there is actually any need for repairs or maintenance, and failure of a carrier to comply with these regulations will render the airline liable to loss of its operating certificate, to criminal penalties, or both.

Every hour that airline aircraft are operating, during a taxable year, and are producing income, establishes a liability and legal obligation on the part of the airline to overhaul the aircraft and the aircraft engines, and brings the time of that overhaul that much nearer. Each hour of aircraft operation, therefore, should bear an appropriate portion of the overhaul expenses. The establishment and maintenance of a reserve for such overhauls is the technique which the Civil Aeronautics Board has approved for that purpose. This technique was recognized for tax purposes by the enactment of section 462, based on accounting principles approved by both the American Institute of Accountants and the Comptrollers Institute of America.

Unless there is recognition, for tax purposes, of reserves for aircraft and aircraft engine overhauls, the result will be that the airlines will have to pay income taxes on funds which are not available for general company use or for distribution as dividends to the stockholders, but which are reserved for the purpose specified.

Many of our member airlines have filed final tax returns for the year 1954. In addition, the annual reports of our members have either been released or are in process of distribution. In reliance on section 462 in many cases these tax returns and annual reports reflect additions to reserves for overhauls and for similar expenses. Moreover, many airlines have made cash commitments, such as for the purchase of new aircraft, based on the allowance as tax deductions of additions to such reserves. Total repeal of section 462 at this time retroactive to January 1, 1954, would work a hardship on these taxpayers.

In view of the foregoing, we urge that, in lieu of such repeal, the pending bill, H. R. 4725, be modified so that it has the effect of preserving the accounting principle on which section 462 is based while at the same time amending that section to avoid the loss of revenue which would result from the section as presently drawn. Your committee has before it a number of effective recommendations designed to reduce that revenue loss, including the so-called stretchout recommended by the American Institute of Accountants.

This association respectfully requests that this letter be included in the printed record of your committee's hearings on H. R. 4725.

Very truly yours,

E. F. KELLY,
Vice President, Finance and Accounting.

STATEMENT CONCERNING THE PROPOSED REPEAL OF SECTION 452 AND SECTION 462 OF THE INTERNAL REVENUE CODE OF 1954, BY E. C. STEPHENSON, THE NATIONAL RETAIL DRY GOODS ASSOCIATION, NEW YORK, N. Y.

This statement is for the purpose of presenting the position of the association on House bill H. R. 4725 passed by the House of Representatives on March 24, 1955, which proposes to repeal, retroactive to January 1, 1954: Section 452 of Internal Revenue Code of 1954 which covers methods for reporting prepaid income earned over both short or indefinite periods of time and over a long period of time and section 462 covering methods for reporting reserves for estimated expenses.

The National Retail Dry Goods Association is a trade association with a membership of over 7,000 department and specialty stores operating in all 48 States, the District of Columbia, Hawaii, and Alaska. These stores employ many thousands of people and do between 11 and 12 billions in total annual sales.

Retailing has a particular interest in these measures because of the many and varied ramifications of its business activities.

Section 452 of the 1954 Internal Revenue Code corrects a glaring inequity which existed in previous tax laws, for the reporting of taxable income. As your committee is well aware, previous to the enactment of this section of the code, the taxpayer was required to report as taxable income in the year of receipt, and pay taxes, on deposits, prepaid rentals, prepaid interest and other forms of prepaid income for which the taxpayer would be required to deliver merchandise or services at some future time, although the applicable expenses or cost of merchandise, or provisions for such costs were not allowable until the period in which such costs were incurred.

While section 452 does not give complete relief to the inequities of former tax laws, it does materially soften the impact of the tax burden. Its provisions for spreading the reporting of such prepaid income gives the taxpayer some considerable relief without placing an undue drain on the Federal revenue. In fact, it is probable taking all taxpayers into consideration with the different problem each has for the deferring of prepaid income that the impact on the Federal revenue will be very slight, while at the same time the effect of the deferring of income to the individual taxpayer would be very important.

Our association believes that this section should remain in the law, that it would be a grave injustice for it to be repealed, and recommends that your final and considered decision should be to permit it to remain as a part of the Federal Tax Code.

Section 462, covering Reserves for Estimated Expenses, corrects a condition that has been clearly recognized by all business enterprises and by all practitioners in the public accounting field. It brings costs applicable to a given taxable year, but incurred in a subsequent taxable year into proper relationship with the revenues of the given taxable year. It brings income tax accounting for revenues and applicable costs into line with sound accounting practices. It represents the first recognition that the Treasury has given to this very perplexing problem. Members of both Houses of Congress have publicly admitted that section 462 properly corrects tax accounting, and believe it should remain in the code according to articles which have appeared in newspapers, but seek its repeal because of the impact on the Federal revenue.

There is no doubt that the impact will be far greater than the estimates made by the Treasury at the time section 462 was enacted by Congress. In fact, some of those who appeared before the Ways and Means Committee to discuss section 462 before the 1954 code was enacted, stated that the impact would be very heavy if the effect was to be absorbed in one year's revenue, and recommended that the application of the section should be spread over a 3-year period.

Our association believes it would be improper and unfair to repeal this very important provision of the tax code. Section 462 corrects an inequity that has existed for years, with no known way to correct it. Our association realizes also that something should be done to soften its effect on the Federal revenue. Therefore, we suggest that the right to the deduction for reserves for estimated expenses should be spread over a 5-year period as follows:

For the reserve established at the first year end a deduction of one-fifth would be permitted.

For the reserve established at the second year end, a deduction of two-fifths less the first year allowable deduction would be allowed.

For the reserve established at the end of the third year, a deduction of three-fifths less the sum of the allowable deductions for the first 2 years would be permitted and the plan to continue for the fourth and fifth years. After that time each subsequent year's operation would require no further adjustments.

In fact, rather than to eliminate this very proper and important section 462 from the Internal Revenue Code, and providing that a 5-year stretchout does not sufficiently relieve the burden on the Federal revenue then our association suggests that the stretchout period be increased to 10 years. This would conform to the provisions in the code for amortizing past service pension costs, when setting up new pension plans.

There might be other provisions written in this section of the code, limiting the right to deduct estimated expenses to certain specific items of expense such as reserves for vacations reserves for warranties and guaranties and others to be determined by conferences between the Representatives of Congress and those representing industry groups.

Our association believes further, that the very proper effect of section 462 on the taxable income of the taxpayer softens to some very minor degree the very severe effect of section 6016 (a), (b), (c), (d), (e) and (f) which requires every corporation for each of the years 1955 to 1959 inclusive, to pay 110 percent of its

income-tax obligations with no opportunity to recover the overpayment unless it either fails or goes out of business.

Therefore, our association urges your committee to retain section 462 in the tax code, and in order to make this possible, to write adequate methods of stretch-out of its impact into the wording of the section.

HYGEIA REFRIGERATING CO.,
Elmira, N. Y., May 12, 1955.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR HARRY: The enclosed copy of letter to Styles Bridges expresses my reaction to the statement in his letter indicating that the sentiment weighs heavily in favor of the proposed retroactive repeal of the tax provisions and that the legislation will probably pass.

I respectfully commend to your thoughtful consideration some of the views expressed in my letter to him.

With warmest wishes,

Sincerely yours,

J. R. SHOEMAKER.

HYGEIA REFRIGERATING CO.,
Elmira, N. Y., May 12, 1955.

Hon. STYLES BRIDGES,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: Your very frank and forthright statement of the situation concerning the tax repeal bills is appreciated. I have had similar statements from others, but no one has yet come up with any sound justification for the action, other than that the Government needs the revenue. No consideration is apparently being given to the equity or fairness of the retroactive procedure, other than that the Government wants the revenue regardless of who is crucified in the process or how much economic damage may be done to the business units striving to produce earnings and consequent tax revenue to the Government.

Billions for faraway lands and wanton waste permeating every facet of the Government, as clearly pictured by the reports of the Hoover Commission, but little apparent effort to change that picture as long as the revenue to maintain it can be squeezed out of business and the people of the country.

Senator, I have long had the thought that one of our greatest weaknesses is that so many Members of Congress have known little about the real factors of business responsibility—the maintenance of a sound economic position with a high level of employment and the inevitable meeting of weekly and monthly payrolls. If this situation were otherwise, I am sure a different point of view might often prevail in place of such shortsighted ones as illustrated by the legislation under discussion.

As you well know, there is nothing personal in this statement, but it comes from the deep sense of injustice that exists in so many angles of the picture.

With all good wishes,

Sincerely yours,

J. R. SHOEMAKER.

P. S.—Since dictating the foregoing, there has come to my desk a memorandum outlining the justification for section 452 of the Internal Revenue Code as amended in 1954, and its application to particular factors and procedures in our industry. This memorandum was prepared by one of the ablest executives in the industry. I think it will be of interest to you.

MEMORANDUM RE SECTION 452 OF THE INTERNAL REVENUE CODE, AS AMENDED IN 1954

There are two major respects in which this provision of the law affects our industry. I will deal with them separately.

In general, however, charges to the customers of the refrigerated warehouse industry are due in advance but customarily are not billed until the end of the month. The charges for handling the goods in and out of the warehouse are billed on receipt of the goods and represent compensation or revenue to the warehouse

for services of receiving and storing the goods and the service of delivering the goods on call from the customer.

For a very long time—at least 30 years—it has been the practice of this company to defer from each month's billing for handling service a portion of that revenue as revenue to be absorbed in the month in which the goods were delivered from storage. At December 31, the close of our tax year, there is therefore, on our accounts as a deferred revenue item an amount reserved for revenue in succeeding months when the goods shall be delivered from storage. As stated before, this has been the practice of this company for a long period of years.

For a considerable part of that time the Federal tax authorities permitted the deferral of this income and did not include it in taxable income in the year in which it was billed. The attitude of the Federal tax authorities on this subject was not uniform and some years ago, in attempting to make it uniform, they forced the disallowance of the deferment of this income, though the deferral was set up on our books and had been a long established practice. We continued to set up this deferral even though it was disallowed by the taxing authority.

This situation illustrates the intent of the 1954 amendment to bring the tax rulings in accord with the established and recognized business principles of accounting.

The second matter of importance to our industry under this section arises from the fact that storage charges are set up as a credit to revenue in the month in which goods are received for storage and cover the storage charges from the date received to the same date in the following month. The bills, however, are not rendered to the customer until after the end of the month. Therefore, there arises the situation at the close of the taxable year where a proportion of the revenue taken in by the warehouse and subjected to taxes by the Federal taxing authorities is neither billed to the customer nor collected in cash. Section 452 provided the basis for proper accounting treatment of this situation in accordance with generally accepted accounting principles.

As to both of these items, it should be pointed out that the effect on taxable income to the Government is temporary and over the long run will make no difference in the tax revenue to the Government, but will enable business to conduct its accounting properly and more realistically without suffering a penalty in tax therefor.

NEW YORK STATE ASSOCIATION OF
OF REFRIGERATED WAREHOUSES,
Elmira, N. Y., May 9, 1955.

Hon. HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR HARRY: Thank you for your note advising that your committee is starting hearings on the tax-repeal bills this week.

May I assume that my letters to you on this subject will be put in the record and that it will therefore not be necessary to appear personnaly at the hearings? There is little I could add to the statements on the subject as covered in our correspondence, except to again say that it is our earnest hope that in all fairness the committee will eliminate at least the retroactive provisions of the House bill.

With kind personal regards.

Sincerely yours,

J. R. SHOEMAKER.

NEW YORK STATE ASSOCIATION OF REFRIGERATED WAREHOUSES,
Elmira, N. Y., May 3, 1955.

Hon. HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR HARRY: Thanks for your note of April 26 on the subject of the tax legislation. For your information, I am enclosing copy of the reply I received to my letter to Secretary Humphrey, made by a special assistant to the Secretary. Also enclosed is copy of my further letter to him, which emphasizes some points already made and brings out some additional angles.

I have before me the special dispatch to the New York Times dated May 1 indicating that "The Senate Finance Committee is keeping the door ajar, if only slightly, for a possible compromise on repeal of two 1954 tax laws entailing unintended windfalls to business." Certainly business has urgent need of some "breaks" in the tax picture. They have been few and far between for many

years. Knowing your innate sense of fairness, I am confident you are going to deal justly with this retroactive proposal, which is extremely unjust and will work a great hardship in many instances.

Based on the last paragraph of the special assistant's letter, one might conclude that they are expecting some compromise in the picture. As I said in my first letter to you on this subject, if the law as passed is unsound, repeal it, but don't enact a retroactive provision that will crucify those who have closed their 1954 business in good faith based on the law as it stands on the books.

Thank heaven we have a man of your sound judgment to deal with this vitally important matter.

Sincerely yours,

J. R. SHOEMAKER.

HYGEIA REFRIGERATING CO.,
Elmira, N. Y., April 21, 1955.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

MY DEAR FRIEND: Supplementing my letter to you of April 1 on the subject of the tax-repeal legislation, I am enclosing copy of letter on the same subject I have just written to Secretary Humphrey, because almost everyone we have heard from on this has taken refuge in the fact that Secretary Humphrey wants it.

According to various items that have appeared in the press, your Senate Finance Committee is seeking ways and means to relieve the situation without actual repeal. Just what form this may take I don't know, but with all the earnestness at my command I again appeal to you to set your face strongly against any retroactive action because, in my book, it is unfair and un-American.

With warmest wishes, believe me,

Sincerely yours,

J. R. SHOEMAKER.

HYGEIA REFRIGERATING CO.,
Elmira, N. Y., April 21, 1955.

Hon. GEORGE M. HUMPHREY,
Secretary of the Treasury, Washington, D. C.

DEAR MR. SECRETARY: No Secretary of the Treasury since the late great Andrew Mellon has merited and received the confidence of the people of this country to the extent that you have. Past expressions I have made to you have affirmed this fact. However, I must in all frankness say that there is apparently a very marked difference of opinion between us with respect to the repeal of certain sections of the 1954 tax law, with reference to the handling of certain business expenses from an accounting standpoint. If this is proving to have been a serious mistake and is in need of further change, no straight-thinking person will object, but what people in business do object to is the retroactive provision of this proposed repeal.

Under date of April 1, I wrote my good friend Senator Harry Byrd, per copy enclosed, setting forth my views on this subject. If you can find time to review this letter, it will give you a clear understanding of my point of view. Similar letters were written to other Senators and Congressmen and in many instances they replied that their reason for support of the retroactive provision was that you had been quite insistent that it be included. There may be something to this that taxpayers generally do not understand and, if so, I would like to have it clarified. It is going to hit many businesses very hard, and I can't help thinking that it has the appearance of being somewhat unfair due to the fact that the 1954 business has been closed and operations and accounting set up accordingly.

I am sure there are many like myself who would be deeply gratified if you could see your way clear to withdraw your insistence on the retroactive provision. In any event, I will very much appreciate your frank comments on the views expressed.

With continued assurances of esteem, I am,

Sincerely yours,

J. R. SHOEMAKER.

APRIL 1, 1955.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR: Even though you have not heard from me very frequently, please know that I have been following closely your splendid acts of leadership both through the press and through the various releases you have kindly had sent to me. In common with all thoughtful people, I certainly continue to commend your efforts toward cutting expenses and toward somehow, some day, coming up with a balanced budget.

I do, however, have a very strong feeling of injustice because of the proposed retroactive repeal of certain sections of last year's tax law which permitted reserves and deferments in connection with certain types of business expenses. If it is soundly and reasonably believed that these provisions are not justified, then a resetting of the picture may be proper, but by no stretch of the imagination can retroactive action in this matter be considered as either proper or fair to business. Books have been closed for the year and, in the case of corporate business, tax returns made up and taxes and dividends paid. To go back now and force a complete resetting for the past year comes at least very close to being in the ex post facto category, against which I thought we were protected by the Constitution.

Business, particularly smaller independent business operating under the corporate form, has suffered some pretty severe disappointments taxwise. A reduction in the heavy burden of corporate taxation has been twice postponed, thereby confirming the belief that it was originally enacted largely to mollify business and make it think it was going to get a break. In my opinion, if the time was not right to do it, then the reduction should never have been enacted in the first place. However, once enacted, postponement creates uncertainty and loss of confidence in the soundness and judgment of both Congress and the administration.

Frankly, I was very much jolted by the recent statement of our very able Secretary of the Treasury (and I do feel that he is that) to the effect that 70 errors were made in the 1954 tax law that should be corrected. I am sure you will agree that if that be true it doesn't make for public confidence in the judgment or fairness of these charged with the responsibility of drafting and enacting tax legislation. I agree that there were some glaring mistakes in the law, but in opinion there were fully as many of omission as of commission. As you knew from our past correspondence, I have long been an advocate of fairness and equity in taxation, and we both know that the enactments have fallen far short of achieving that result. A feeling that taxes are fair and equitable in their effect is of far greater importance from the standpoint of public reaction than the rate per se.

My friend, I have taken the liberty of expressing these views to you because of your recognized position as the leader in financial affairs of the entire Congress. May the country be privileged to have you continue in that capacity for a long time to come.

With warmest personal wishes, believe me

Sincerely yours,

J. R. SHOEMAKER.

MORTGAGE BANKERS ASSOCIATION OF AMERICA,
Washington, D. C., May 10, 1955.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am writing as general counsel of the Mortgage Bankers Association of America concerning the proposed legislation to repeal retroactively section 452 of the Internal Revenue Code of 1954.

This association strongly urged the enactment of section 452 when it was originally proposed, since the use of the provisions of the section would enable many members of this association to adjust income earned under a servicing contract on a proper basis and to build up reserves for possible losses.

The association feels that the provisions of section 452 are entirely proper and should not be repealed. It is the feeling of many members of the association that most of the problems which have arisen have arisen by reasons of the provisions of section 462 of the Internal Revenue Code of 1954. Accordingly, we feel it

would be a great mistake to deny the advantages of the present section 452 to businessmen throughout the country who have for a long time looked forward to an equalization of income during the entire period over which it is earned. This association, therefore, urges your committee in the alternative either to permit the present provisions of section 452 to remain in effect or to permit, in any alternative legislation proposed, the application of the method under which prepaid income may now be handled under section 452 by mortgage companies.

In order to explain how section 452 was of benefit to mortgage companies, I am taking the liberty of forwarding with this letter, and asking that it be incorporated in the record, a letter dated November 24, 1954, addressed to the Assistant Commissioner, Technical Division, Bureau of Internal Revenue, with enclosure, and a letter from a typical mortgage company (in this case, United Service and Research, Inc., Memphis, Tenn.) dated March 19, 1955, and addressed to the Clerk of the Committee on Ways and Means of the House.

Sincerely yours,

SAMUEL E. NEEL.

NOVEMBER 24, 1954.

Re section 452, Revenue Code of 1954

ASSISTANT COMMISSIONER, TECHNICAL DEPARTMENT,
Bureau of Internal Revenue, Washington 25, D. C.

DEAR SIR: This letter, with its enclosure, seeks a ruling from the Commissioner with regard to the application of section 452 of the Internal Revenue Code of 1954 to income derived by a mortgage company from a servicing contact which it may have with a principal investor.

An explanation of the facts upon which this request for a ruling is based follows:

It is typical of the operations of a mortgage company in the home mortgage field for the company to undertake for a consideration to originate a mortgage loan on a piece of residential real estate in the locality in which the mortgage company is located; to supervise the making of the loan on the premises; and when the loan has been made, to find an investor (frequently located at a considerable distance from the locality in which the real estate is located) which is willing to purchase and own the loan.

The investor represented by the mortgage company is known as a "principal." The mortgage company and the principal have a contractual relationship. The mortgage company undertakes to handle all matters relating to the loan for the principal during the entire life of the loan. The mortgage company represents the principal in all its dealings with the borrower. The mortgage company must make sure that payments of principal and interest are made when due, that taxes and other payments are made when due, that adequate insurance is carried by the borrower, etc.

For these services, and particularly with reference to loans that are amortized over a long period, the typical contract between an investor and the mortgage company provides that the mortgage company will receive compensation on the basis of one-halfof a percent annually of the outstanding principal balance of the loan. Obviously, under such an arrangement, as the outstanding principal balance of the loan declines, the amount of compensation received annually by the mortgage company will also decline. For example: On a $10,000, 25-year loan, at 4½ percent interest, a servicing agent receives $49.50 for the first year's servicing and $1.80 for the last year's servicing.

Since the obligations of the mortgage company as servicing agent are identical in the first year of the loan and in the last year of the loan, there is almost no difference in the actual operating cost to the servicing agent between the cost of servicing in the early years of the loan and those incurred in the later years of the loan.

For some years the Bowery Savings Bank of New York City, in an effort to avoid the variation in servicing income pointed out in the preceding paragraph, has required all their servicing agents to enter into a contract which they term the "Level Income Servicing Contract." Under this contract the servicing agent agrees to take a stated amount of servicing income each month during the life of the loan and this amount remains constant even though the principal unpaid balance of the loan declines from month to month. Under this arrangement, for example, on a $10,000, 25-year loan, at 4½ percent interest, with a one-half percent servicing fee, the servicing agent receives $30 per year for the entire life of the loan. The formula is based on 25 cents per $1,000 per month. The difference between the level monthly payment and what would be the usual monthly

payment accumulates to the credit of the servicing agent and is held by the Bowery to be paid out during the later months of the life of the loan. In the event that a loan is paid off prior to maturity, then the Bowery pays to the servicing agent any accumulated funds standing to its credit, and these funds are taken into income by the servicing agent as paid.

This sytem effectively results in a postponement of income and the resulting tax thereon, and it may be accomplished under the present tax laws, since the excess funds are actually held by the Bowery and never come into the possession of the servicing agent until paid over by the Bowery. Therefore, the accumulated reserves during the early life of the loan are not taxable income.

A servicing agent, however, under the tax laws in effect prior to the enactment of the Revenue Code of 1954 could not utilize the benefits of this system by setting up similar reserves on its own books, since the Internal Revenue Service never recognized such reserves as being proper. Therefore, all servicing income had to be taken into income when received, and while reserves could be accumulated, taxes thereon could not be postponed.

It is the belief of this association that the amounts received by a mortgage company in excess of the "average" monthly payment is very clearly "prepaid income" within the definition of Section 452 (c) (1) of the Internal Revenue Code of 1954. It is also the belief of this association that the liabilities of a mortgage company, under its typical servicing contract, fall within the definition of "liabilities" as defined by Section 452 (c) (2) of the Code.

It is the desire of this association to secure the consent of the Secretary, under section 452 (b) (2), so that a mortgage company may at its election set aside, in the early years of the life of an amortized loan, a specified amount of gross servicing income as a reserve to be taken back into taxable income at a later date.

A detailed proposal showing a typical situation with reference to a specific company, the Detroit Mortgage and Realty Co., is enclosed with this letter.

I realize that the Internal Revenue Service is presently working on comprehensive regulations under section 452 which will be published in proposed rule-making form in the near future.

It is our earnest desire that these regulations include as an example the obligations which a mortgage company incurs by virtue of its servicing contract with its principal as outlined above.

Sincerely yours,

SAMUEL E. NEEL.

DETROIT MORTGAGE & REALTY CO.,
Detroit, Mich., November 11, 1954.

ASSISTANT COMMISSIONER OF INTERNAL REVENUE,
Technical Department, Washington 25, D. C.

GENTLEMEN: A substantial part of our business is the servicing of mortgages for insurance companies, banks and other investors. In this connection we request permission to report this service income on an equal annual basis over the life of the mortgage. Under the present system (which will hereafter be referred to as the "reducing income plan"), we receive $4.95 per $1,000 (on a 25-year, 4½ percent mortgage), for the first year's work and only 18 cents for the last year's servicing fee. There is almost no difference between the actual operating cost from the first to the last year of the life of the loan and still the income for servicing will vary downward as far as 96 percent.

We propose to report the entire service income on an equal annual basis commencing with the calendar year 1954 for new mortgages closed during the year 1954. The excess of the amount received over the amount taken into income in the early years would be credited to a reserve account. The reserve account for the specific loan would be completely cleared out in the later years of the loan and the amount credited to income at the maturity of the mortgage would be the same as under the present system.

In the event the mortgage is paid prior to maturity, the entire balance in the reserve account would be credited to income.

The only difference between the two methods is that under our proposed method the income would be reported on an equal annual basis throughout the life of the mortgage compared with the reducing income plan now employed.

Illustration of proposed plan: Assume the service involved in a $10,000, 4½ percent, 25-year loan with a total of $750 in servicing fees over the 25 years of the mortgage:

(1) Under the present system $49.50 is taken into income the first year and this amount is reduced each year. The last year (25th) this amount is only $1.80 provided the loan is not paid prior to maturity.

(2) Under our proposed method the annual income throughout the life of the loan would be $30 ($750 total fees divided by 25 years life of mortgage). The first year $19.50 ($49.50 minus $30) would be credited to the foregoing mentioned reserve and in the last year the reserve would be charged with $28.20. The interim years obviously would vary proportionately.

The basic purpose of our proposed level income plan is to provide a means of amortizing the income from servicing over the entire life of the mortgage, thereby equalizing the difference between income and operating expense that occurs under the reducing income plan. This method would also place us in a better position to perform our contract commitments with respect to delinquent accounts, in which the FHA and the VA are also vitally interested. A photostatic copy with one of our correspondents, outlining our contractual obligations, is attached. The contract is typical of all our contracts with other principals.

In conclusion we believe we should be granted permission to report our income on the proposed level income plan so as to enable us to report our income more realistically in direct ratio to our operating costs and at the same time our proposal would in no way reduce the overall income to the United States Treasury.

Very truly yours,

ROBERT H. PEASE, *President.*

UNITED SERVICE & RESEARCH, INC.,
Memphis 3, Tenn., March 19, 1955.

CLERK,
Committee on Ways and Means,
New House Office Building, Washington 25, D. C.

DEAR SIR: Our firm is vitally interested in the proposal, now before your committee, to repeal section 452 and section 462 of the Internal Revenue Code of 1954. We urge your support in retaining such sections in the law, and request that your committee clarify the provisions to cover the problem outlined hereinafter.

United Service & Research, Inc., referred to hereafter as "United," is a Delaware corporation, whose principal office is located in Memphis, Tenn. The principal business of the corporation is that of financing real-estate developments, buying, selling, and dealing in real-estate mortgages, and of servicing mortgage loans for permanent investors. The servicing of mortgage loans constitutes the major function of the corporation, and is the subject of this statement relative to sections 452 and 462 of the Internal Revenue Code of 1954.

FACTS

United by contract with a financial institution agrees to service such mortgages as are included under the contract for the entire life of each such mortgage. These mortgages vary in term from 15 to 30 years, the predominant life of such mortgages being 25 years at this date. The service fee paid to United under its contracts with the financial institution is a fixed percentage of the unpaid balance of the particular mortgage being serviced. The customary fee being one-half of 1 percent of the balance of the amortized mortgage each year.

The service performed by United includes the monthly collection of principal, interest, and escrow funds as provided by the mortgage; the remittance of principal and interest to the financial institution (the investor); acting as trustee for the escrow funds, paying the taxes, hazard insurance and FHA insurance from escrow funds; and the preparation of periodic reports to both mortgagor and mortgagee, showing the status of each mortgage. Incident to the servicing is the responsibility of a trustee in the handling of custodial funds, and the exercising of reasonable care in performing the service, both of which require the protection of insurance by the servicing agent.

The cost to United of performing the service set forth above, and which is required of them by their contracts with the financial institution, remains constant throughout the term or life of the mortgage. Specifically, United's service expense on a given 25-year mortgage is the same the first year as it is the last or the 25th year.

PROBLEM

The problem is how can this corporation equalize the gross income from servicing a mortgage, under its contract, over the entire life or term of the mortgage so that during the earlier years the profit realized is not excessive and conversely in the latter years an actual loss on same will not be sustained.

This is best illustrated by showing the actual service fees payable to United under a contract with a financial institution, using a $10,000, 25-year, 4½-percent mortgage, with the service fee computed at one-half of 1 percent of the balance of the outstanding principal, as compared to the average annual fee of such mortgage. (See exhibit A attached.)

Under this mortgage United would receive a service fee of $49.50 the first year, which would result in a substantial profit being realized, and United would receive a service fee of $1.80 the 25th year, which would result in a substantial loss since the expense necessary to service the mortgage in both years would be the same.

ACCOUNTING TREATMENT

The liability of United to service a mortgage under its contract with a financial institution, continues for the full term or life of such mortgage. Generally accepted accounting principles and sound business judgment require that such liability be recognized and provided for. Generally accepted accounting principles dictate that business income and related expenses be correlated as closely as possible within each accounting period.

It is apparent from an examination of the attached exhibit A that the income realized from the annual service fee varies considerably during the term of the contract. The service rendered and the related expenses remain constant during the same term. United proposes to establish a reserve to provide the funds required to continue its service under the contract during the latter years of the mortgage when the service fee will not be sufficient to cover the expenses necessary to provide the service.

The reserve so established will be credited with the excess of service fees received during the early years of the contract over the average service fee as determined by the term of the contract. During the latter years of the contract, as the service fee received falls below the average service fee, the reserve will be debited with the amount of the deficiency.

By use of this accounting concept, the income realized during the term of the contract will be correlated with the related expenses of performing the services specified by the contract. The funds necessary to provide the service will be available when required, and United will be able to maintain a sound financial position throughout the term of its agreements with the financial institutions it serves.

It is the opinion of United that its problem can be solved by proper application of sections 452 and 462 of the Internal Revenue Code of 1954.

Sound accounting principles dictate that income received from servicing mortgage loans should be correlated to the expenses incurred in producing such income by the use of reserve. By this means a true and more accurate profit-and-loss statement can be prepared for each year during the life of a particular mortgage servicing contract, and distortions in profit and loss will be avoided. As shown by exhibit A attached, if the procedure is not adopted, the corporation will have several years of comparatively high profits for tax purposes during the first few years of servicing the mortgage and then will have several years of progressively increasing losses during the latter years of servicing the mortgage.

Therefore, it is respectfully requested that your committee retain sections 452 and 462 of the Revenue Code of 1954 in the law, and further that recommendations be made to the Treasury Department to apply same to situations similar to those outlined in this letter.

Respectfully submitted.

E. D. SCHUMACHER, *President.*

EXHIBIT A.—*Proration of service fee collecting over the estimated term of a mortgage—25-year term, 4½ percent, $10,000*

Year	Annual service fee	Average service fee	Over or under (−) average	Year	Annual service fee	Average service fee	Over or under (−) average
1	$49.50	$29.66	$19.84	15	$27.06	$29.66	−1.70
2	48.36	29.66	18.70	16	25.80	29.66	−3.86
3	47.16	29.66	17.50	17	23.64	29.66	−6.02
4	45.96	29.66	16.30	18	21.24	29.66	−8.42
5	44.64	29.66	14.98	19	18.84	29.66	−10.82
6	43.32	29.66	13.66	20	16.32	29.66	−13.34
7	41.88	29.66	12.22	21	13.68	29.66	−15.98
8	40.44	29.66	10.78	22	10.92	29.66	−18.74
9	38.88	29.66	9.22	23	7.92	29.66	−21.74
10	37.20	29.66	7.54	24	4.92	29.66	−24.74
11	33.52	29.66	5.86	25	1.80	29.70	−27.90
12	33.72	29.66	4.06				
13	31.92	29.66	2.26	Total	741.54	741.54	0
14	30.00	29.66	.34				

STATEMENT RE H. R. 4725 BY NATIONAL ASSOCIATION OF REFRIGERATED WAREHOUSES

The National Association of Refrigerated Warehouses represents over 500 members engaged in the business of storing and preserving our Nation's food supplies.

We strongly urge that the proposal to repeal sections 452 and 462 of the Internal Revenue Code of 1954 be defeated, and these are our reasons therefor.

These sections were enacted for the general purpose of bringing tax accounting more closely into harmony with generally accepted accounting principles.

That section 462 did just that and did eliminate an unfair burden on our industry can be easily demonstrated.

It is the practice of our industry to bill a customer for labor necessary to handle his goods both in and out when the goods are received in the warehouse. Such charges are treated as income and income taxes paid thereon in the year when billed, regardless of when collected. That is so under the 1939 as well as the 1954 codes, and we have no quarrel in that respect. However, under the 1939 code we were not permitted for income-tax purposes to take as a deduction a reserve for the cost of the labor necessary to deliver the merchandise to the customer upon withdrawal from the warehouse. Such denial has been sustained by the courts (*Capital Warehouse Co., Inc., Petitioner* v. *Commissioner of Internal Revenue*, 9 Tax Court of the United States, p. 966, affirmed United States Court of Appeals, Eighth Circuit, 171 F. 2d 395). Under the 1939 code such a deduction could be taken as a practical matter only in the year we go out of business, which we trust will never occur. This is corrected by section 462 of the 1954 code, and in all fairness to our industry and all others unfairly treated under the 1939 code, this section should remain and should not be repealed.

For like good reasons section 452 should be retained, but it requires amendment. As now written it applies only to the deferral of income that is "received," that is, actual receipt of payment. Treasury, in its proposed regulations, applied this section only to payments received. Such an interpretation discriminated against our industry.

Warehouses as a rule bill a customer for 1 month's storage in advance from the date the goods are received. For example, if a shipment is received on December 31, the customer is billed for storage from December 31 to January 30 of the next year. Those warehouses that keep their books on the accrual basis and report on a calendar year must report that December 31 billing as income in the year billed. So it has been held by Treasury and the courts (*Your Health Club, Inc.*, 4 Tax Court of the United States, p. 385 and *Spring City Foundry Company* v. *Commissioner of Internal Revenue*, 54 Supreme Court Reporter, p. 645). Sound accounting principles would defer the portion of such billing as income until the period when earned, i. e., thirty-thirty-firsts of such billing to January of the next year. Since the purpose of section 452 was to bring tax accounting more closely into harmony with generally accepted accounting principles, we should have been permitted to defer the income applicable to the next year. Treasury, however, said no.

Under Treasury's interpretation a taxpayer that received payment for rents in advance could defer the unearned portion, whereas the warehouse that did not

receive any money could not so defer. That would give the taxpayer with the cash the right to defer the payment of tax, but the warehouse with an account receivable but no cash would not be permitted to defer the payment of tax. We are sure Congress did not mean to create such an inequitable situation, and we request that section 452 be amended so as to eliminate that unfairness.

We further protest the repeal of sections 452 and 462 on the ground that many in our industry have made substantial commitments for enlargement or improvement of plants and properties, expecting to pay them out of any deferment in the payment of tax resulting from those sections. A retroactive repeal of those sections might well prove disastrous to them.

The Secretary of the Treasury has fears regarding the size of the revenue loss and the possibility of costly litigation. However, as has been suggested, only two simple amendments would be required: (1) have a transitional period; and (2) clarify the Treasury's jurisdiction over the items included in estimated expenses.

As to both sections 452 and 456, it should be pointed out that the effect on taxable income to the Government is temporary and over the long run will make no difference in the tax revenue to the Government, but will enable business to conduct its accounting properly and more realistically without suffering a penalty in tax therefor.

For these reasons we respectfully urge that section 452 be amended and that section 462 be not repealed.

STATEMENT BY THE AMERICAN PAPER & PULP ASSOCIATION CONCERNING H. R. 4725, A BILL TO REPEAL SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

This statement is submitted on behalf of the American Paper & Pulp Association in opposition to H. R. 4725. The American Paper & Pulp Association is the overall trade association for the paper and pulp industry in the United States. The paper and pulp industry is the fifth largest industry in this country and has a total investment of $7,600 million, with annual sales approximating the same amount.

H. R. 4725 would repeal retroactively sections 452 and 462 of the Internal Revenue Code of 1954. Section 452 relates to prepaid income and section 462 deals with reserves for estimated expenses. It would be helpful to consider the genesis of both these sections. Under the Internal Revenue Code of 1939, it was provided that the net income of a taxpayer should be computed in accordance with the method of accounting regularly employed by the taxpayer if such method clearly reflected his income. Regulations issued under the 1939 code stated that approved standard methods of accounting would ordinarily be regarded as clearly reflecting taxable income. Nevertheless, as a result of various court decisions and rulings, many divergencies developed between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The areas of difference which arose under the 1939 code were confined almost entirely to questions of when certain types of income and expenses should be taken into account in arriving at net income.

Sections 452 and 462 represented an honest attempt by the Congress to conform tax accounting to business accounting. For example, under the 1939 code, payments received in advance for the use of property in future years or for services to be rendered in future years were includible in the income of the recipient in the year in which received, irrespective of the fact that the tax-payer might or might not be using the accrual basis. Well-established accounting procedure provides that in the case of those taxpayers employing an accrual accounting system, receipts from rentals and the like should be included in income in the year in which earned and in the year any related expenses are incurred, which is not necessarily the year of receipt. Section 452 permits accrual basis taxpayers to defer the reporting of advance receipts as income until the year or years in which, under the taxpayer's regular method of accounting, the income is earned. However, the period over which the prepayments may be deferred can not exceed 5 years after the year of receipt.

Let us consider section 462 which deals with reserves for estimated expenses. Under the 1939 code, deductions for expenses and losses incurred by a taxpayer could be taken only when all events had occurred which fixed the fact and the amount of the taxpayer's liability. In many situations, this would be at variance with generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account. Section 462 of the 1954 Internal Revenue Code merely serves to 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. These expenses must be related to income taxed during the year except for adjustments or corrections of previously established reserves, and more important, the expenses must be allowable deductions which the Secretary of the Treasury or his delegate—the Commissioner of Internal Revenue—is satisfied can be estimated with reasonable accuracy. A reserve can be considered reasonably estimated when it is based on reliable data or statistical experience of the taxpayer or others in similar circumstances. It is obvious that reserves for general contingencies, indefinite future losses or obligations, or for amounts in litigation cannot fall into this category.

Why is the Congress and more particularly the Finance Committee considering a bill such as H. R. 4725 which would repeal retroactively sections 452 and 462—sections which have put into the law good commonsense accounting? As a matter of recent history, there were a number of allegations without any apparent foundation in fact that these sections might involve a loss to the Federal Treasury of enormous amounts, amounts ranging up to $5 billion. Testimony before the Ways and Means and Finance Committees, when the Internal Revenue Code of 1954 was being conceived, indicated that the loss which might be brought about by the enactment of these sections would not exceed $47 million. The Secretary of the Treasury has recently suggested in a letter to the chairman of the Ways and Means Committee that sections 452 and 462 "if permitted to remain in the law, * * * will cause a greater loss in revenue than estimated"; that is, greater than $47 million.

The American Institute of Accountants has conducted a careful survey of some 13,668 corporations with net income before taxes for the year 1954 of $19,200 million. These corporations had made provisions of $8,400 million for Federal taxes which, in the honest opinion of this respected organization, would have been $8,600 million without section 462; and, as this was estimated to be half the national total, there would be involved at most a transitional revenue loss of $400 million.

The Secretary of the Treasury contends that not only would sections 452 and 462 occasion a loss in revenue—which indeed was contemplated at the time of enactment of these sections—but also would bring about considerable litigation. The suggestion has been made that the Commissioner cannot promulgate regulations which would be sufficiently definite and with adequate standards to insure avoidance of such litigation. We suggest that rather than to repeal two sections of a law which represent a forward step in reconciling tax accounting with business accounting, it would be in the public interest for the Commissioner of Internal Revenue and his assistants to spell out with particularity proper regulations under these sections of the law. To argue that because a section of the tax law will foster litigation is sufficient reason for seeking its repeal would indeed require a complete repeal of every section of the entire Internal Revenue Code.

It is our considered opinion that section 452 and section 462 should be given a fair trial with proper regulations and not be disturbed at this time. We oppose H. R. 4725 and urge most strongly that it be not reported from this committee.

Respectfully submitted.

E. W. TINKER, *Executive Secretary.*

NATURAL GAS PIPELINE CO. OF AMERICA,
Chicago, Ill., May 9, 1955.

Re Proposed amendment of section 462, Internal Revenue Code of 1954.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: During the past decade many attempts have been made by well-informed taxpayers, the Internal Revenue Service, and Members of the Congress to coordinate income-tax procedures in close relationship to accounting procedures. Considerable success to this end was achieved in the passage of the Internal Revenue Code of 1954. Thus in keeping with general accepted accounting principles, section 462 of that code was enacted to permit the deduction of reserves for estimated expenses in computing taxable net income. At the time the provisions of section 462 were considered by the committees of the House and Senate and the Congress at large, it was recognized that for the year in which reserves were first claimed a double deduction would occur; namely, for expenses

actually incurred in the current year attributable to current or prior year's income and for reserves for future expenses attributable to the current year's income. Coincident with the consideration of this section of the code, the Secretary of the Treasury informed the committees the probable tax loss resulting from the enactment of section 462 and section 452, the latter, relating to the deferment of prepaid income, would not exceed $47 million. Since enactment of the 1954 code, revenue losses due particularly to taxpayers' use of section 462 have been estimated in excess of $1 billion. Disturbed at this alarming sum the Secretary of the Treasury has recommended repeal of section 462 as well as section 452. To accomplish that purpose H. R. 4725 and H. R. 4726 have been introduced.

It is apparent the repeal of section 462 is sought because of the immediate substantial estimated internal-revenue loss and not for the reason the objective of the section would in fact bring tax procedure in harmony with accepted accounting procedure. Thus to accomplish the real objective intended at the time of the initial enactment of section 462 and with the minimum deferment of tax revenue, it is recommended section 462 be amended to provide in the year election is made to apply the deduction of reserves for estimated expenses, the taxpayer shall be entitled in said taxable year to deduct the greater amount of (1) expenses actually incurred in the current year attributable to current or prior taxable years, or (2) reserves for estimated future expenses attributable to the current year's income. With respect to items (1) or (2) not taken as a deduction in full in the current taxable year, such item shall be treated as deferred expenses, and shall be allowed as a deduction ratably equivalent to the composite rate of depreciation allowed. For the succeeding taxable year or years the taxpayer shall be required to use the reserves for estimated future expenses unless with the consent of the Secretary or his delegate the taxpayer is permitted to use a different method. Freedom from a prior election should be accorded taxpayers where material changes occur in tax statutes or status of the taxpayer.

Should section 462 be amended as here recommended, it is apparent taxpayers will elect to secure deductions of reserves for estimated future expenses as these in most instances will exceed in amount actual expenses attributable to the current or prior taxable years. But significantly the recommended amendment would not permit a complete double deduction of both current and future expenses. In fact under the recommended amendment the revenue loss may well be much less than the original estimate made by the Secretary of the Treasury.

The proposal here suggested is somewhat akin to the transition of the tax-collection system applicable to individuals to the current pay-as-you-go method. This transition was accomplished by canceling as of September 1, 1943, the tax liability for the taxable year which began in 1942, thus avoiding the payment of 2 years' taxes in one. Similarly, in the instant case, during the transition from the current to the future expense-deduction basis, one and a ratable proportion of the second rather than two deductions would be allowed. Surely in the interest of attaining better accounting principles and practices in the Revenue Code, this procedure would not evoke any merited criticism on the part of taxpayers. Since the privilege to engage in the transition from a current to a future liability determination is suggested on the premise of an elective basis, taxpayers would be the sole arbitrators of ensuing tax consequences. We are confident taxpayers are willing to assume this responsibility for the practical advantages the reserve basis of deductions will afford.

Respectfully submitted.

C. B. RANDALL, *Tax Attorney.*

NATIONAL LAWYERS GUILD,
New York, N. Y., May 10, 1955.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR BYRD: We note your announcement that your committee plans to hold hearings with respect to H. R. 4725, a bill to repeal sections 452 and 462 of the Internal Revenue Code of 1954.

Section 452 permits, with limitations, accrual-basis taxpayers to defer the reporting of income by way of advance payments for services performed, goods furnished, use of property and so on, until the year or years in which the income is earned. Section 462 permits accrual-basis taxpayer to deduct, in certain cases, additions to reserves for various types of estimated expenses. Under section 462, eligible taxpayers, in the first year, could also deduct expenses already paid in

the 12 months covered by their tax returns. Consequently, such taxpayers would receive a double deduction in the transitional year.

We recognize that the original objective of these two sections was simply to conform tax accounting with business accounting. However, it was never intended that these provisions would result in a substantial loss of revenue or result in windfalls to taxpayers.

The tentative regulations issued by the Treasury, for implementing these statutory provisions, have come under vigorous attack as being too restrictive in limiting the intended application of the statutory provisions. We understand, too, that taxpayers have served notice that they intend to litigate such regulations.

The testimony induced before the Ways and Means Committee on H. R. 4725 indicates that the revenue losses will far exceed the original estimate of $47 million.

However commendable the objective of conforming tax accounting with business accounting, sections 452 and 462 suffer from the basic defect that they were not sufficiently limited in their application, nor was the revenue impact of the changes sufficiently restricted. For these reasons, repeal, rather than amendment, is now dictated so that in any new approach to the original objective the revenue is adequately protected. Moreover, it must be borne in mind that repeal of these two provisions will reinstate the legal rights of all taxpayers just as they were under the old law prior to last August, when the 1954 Code was enacted, and most importantly, protect the Government from revenue loss which was never intended by the Congress. The fact is that a complete overhauling of the 1954 Code should be undertaken, mindful of the relatively hasty manner in which this most complicated legislation was handled during 1954.

Accordingly, we urge your committee to approve H. R. 4725.

We respectfully request that the views herein set forth be inserted in the record of hearings contemplated on H. R. 4725.

Respectfully submitted.

JOSEPH H. CROWN,
Chairman, Taxation Committee.

PENNSYLVANIA RANGE BOILER CO.,
Philadelphia, Pa., May 7, 1955.

Subject: Proposed repeal of section 462, I. R. C.

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

GENTLEMEN: I believe that your committee has a report of a survey conducted by the American Institute of Accountants on the amount of additional tax that would be paid by those companies that took the benefit of section 462, if this section were repealed and that this indicated a total loss of revenue with the section in force, of about $500 million, which is a great deal less than the estimate of the Treasury Department. There is every expectation that most companies will have good years in 1955 and the larger ones will be commencing to pay tax in advance under the new system of paying corporate income tax.

There has been in the law for many years a section permitting the use of a reserve for bad debts.

It is only fair that those companies, that are selling products with warranties that obligate the manufacturer to make replacements of parts or the entire product during the warranty period, should not have to include the full selling price in the sales of the year which the merchandise is shipped when it is obvious that there will be expenses to make good under the warranties. If tax payers set up, under section 462, too much in the way of such reserve, hindsight will indicate the excess and the Treasury Department will reduce the reserve set up by the amount of the excess. This type of reserve should have been permitted by law long before this.

The so-called double deduction occurs only once and there are actually not double deductions at all. For instance, assume a manufacturer's gross billings in 1954 of $10 million where warranties are involved that are estimated to ultimately cost the taxpayer $200,000. When he makes good on the guaranties, the charges will go against the reserve and not against income. The transition year 1954 gives rise to a deduction under section 462 for the estimate of the expenses to be made under the warranties on the sales of that year only. Expenditures in 1954 under warranties on shipments of prior years are likewise deductable but there are not two deductions with reference to the same particular item such as a refrigerator.

If the members of the committee would mentally place themselves in the position of such manufacturers and think this matter through, I am sure they

would come to the conclusion that section 462 not only belongs in the law but that some such section should have been in the law for many years past. Section 462 is an equitable section and, if for 1 year there is some loss of revenue, it should be made up in some other way.

My personal opinion is that incorporated businesses are carrying far more than their share of the load as compared with unincorporated businesses.

Why not also take a look at that section of the law which allows life beneficiaries of a trust a deduction for items such as legal expenses that are chargeable to the principal (corpus). A more ridiculous provision could hardly be imagined.

Very truly yours,

LEE K. CARR,
Vice President and Controller.

THE WESTERN UNION TELEGRAPH CO.,
New York, N. Y., May 9, 1955.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR BYRD: This letter is submitted in accordance with the recent announcement in the press whereby the Senate Finance Committee invited interested parties to file written statements regarding the retroactive repeal of section 462 of the Internal Revenue Code of 1954 proposed by H. R. 4725.

It is respectfully requested that the following views and comments be considered by the Senate Finance Committee:

I. Western Union has materially changed its legal and economic position in reliance upon the availability to it in 1954 of section 462.

Section 462 of the Internal Revenue Code of 1954 is effective for all taxable years commencing after December 31, 1953, and ending after August 16, 1954. In reliance thereon, Western Union has prepared and issued to its stockholders and to the investing public at large its annual financial statements based upon the express premise that reserves authorized by section 462 were deductible. In addition, pursuant to the requirements of the Treasury's proposed regulations (sec. 1,462-1 (a) (2)), Western Union in its financial statements issued to the public at large and filed with the applicable regulatory authority, the Federal Communications Commission, has deducted the full amount of its section 462 reserves for estimated expenses as a charge to current income.

In reliance upon Western Union's financial statements for 1954, the directors of Western Union, after the close of the calendar year 1954 but prior to any suggestion on the part of the Congress that the benefits extended by section 462 might retroactively be repealed, on February 8, 1955, increased the dividend payable April 15, 1955, on its capital stock from 75 cents to $1. Further, the directors on said February 8, 1955, proposed and submitted to stockholders a proposal to split the corporation's stock 4 to 1, which proposal was favorably acted upon by the stockholders at the annual meeting held April 13, 1955.

In addition to the foregoing changes of legal and economic position, Western Union has computed its Federal income-tax liability for the calendar year 1954 on the basis of its section 462 reserves being deductible. Pursuant to law, Western Union on March 15, 1955, paid 50 percent of the tax so computed to its local director of Internal Revenue.

It is thus apparent that Western Union, in recognition of the express terms of the Internal Revenue Code, has filed with the Federal Communications Commission and issued to its stockholders and the general investing public financial statements based upon the availability to the company of deductions as authorized by section 462. Further, Western Union's directors have increased the company's first 1955 dividend, and, in conjunction with the stockholders, have taken important steps toward effecting a stock split. Finally, the company has calculated its 1954 income-tax liability upon the basis of section 462 being an integral part of the taxing statute, and has paid the statutory percentage of such resulting tax to the Government.

Much has been made by the opponents of section 462 of the alleged fact that its scope is being unduly enlarged by taxpayers. Such cannot be alleged in the case of Western Union, all of whose reserves were clearly envisioned, as demonstrated by the committee reports, as falling within the legitimate scope of section 462. For example, the only section 462 reserves available to and claimed by Western Union are a reserve for vacation pay in the amount of $6,723,000 and a reserve for self-insured casualty losses in the amount of $100,000.

It is thus seen that the sole deductions claimed by Western Union under section 462 relate to reserves which the Congress had in mind in enacting 462. There is no effort here on the part of the taxpayer unduly to extend the terms of the statute to cover items not envisioned either by the Treasury or the enacting Congress. It would indeed be anomalous if the taxpayer were to be denied deductions clearly related to the earning of income in the taxable year which under principles of good accounting are required to be associated with the earning of such income.

II. Objections to a repeal of section 462, Internal Revenue Code of 1954, retroactively for completed taxable years governed by the 1954 code.

Section 462, Internal Revenue Code of 1954, relating to reserves for estimated expenses, became law on August 16, 1954, and is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954 (sec. 7851 (a) (1), I. R. C. of 1954). Consequently, section 462 was applicable to taxpayers who computed income on a calendar year basis in 1954. The current repeal of section 462 retroactively in respect to completed taxable years governed by the 1954 code would be objectionable on constitutional as well as equitable grounds.

1. A repeal of section 462, IRC of 1954 retroactively effective in respect to completed taxable years governed by the code of 1954 on or after the date prescribed for filing income-tax returns for such completed taxable year would give rise to extensive constitutional litigation, which might well result at a later date, in the invalidation of the repeal.

The Federal income-tax returns of corporations for calendar year 1954 must be filed on or before March 15, 1955 (sec. 6072 (b), IRC of 1954). Individual returns covering the 12-month period ended December 31, 1954, are due on or before April 15, 1955 (sec. 6072 (a), IRC of 1954). The computation of tax for 1954 by such taxpayers is governed by the Internal Revenue Code of 1954. In the event that section 462 were repealed on or after March 15, 1955, or April 15, 1955, a question would arise as to the constitutionality of the legislation in respect to the respective corporate and individual taxpayers who were required to file income-tax returns on or before the respective above-mentioned dates. A repeal of section 462 would result in the disallowance of deductions already claimed on returns and allowed under prior law, and would constitute the retroactive imposition of Federal income taxes.

The United States Supreme Court has never had the occasion specifically to pass upon the question of the constitutionality of a retroactive repeal of a previously existing provision of a Federal tax statute enacted after the due date of returns for taxable years governed by such provision. Numerous decisions of the Supreme Court indicate that tax statutes made retroactive for relatively short periods "so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calendar year as preceded the enactment" are consistent with the du-process clause of the Constitution. The repeal of an existing statute governing a prior taxable year at a time subsequent to the close of such year and the due dates of returns, however, would be repugnant to the fifth amendment to the United States Constitution (*United States* v. *Hudson*, 299 U. S. 498, 500 (1937); see also *Blodgett* v. *Holden*, 75 U. S. 142 (1927) and *Heiner* v. *Donnan*, 285 U. S. 312 (1932)).

The Congress in the past has recognized the injustice of retroactive taxation and has resisted the imposition of such taxes. There are three important instances of such forbearance. In the 65th Congress, in 1917, when the cost of war required additional revenue, a proposal (H. R. 4280) was made to levy an additional tax on 1916 incomes. The Finance Committee of the Senate rejected the proposal in the following language:

"Moreover, it is to be remembered that if we admit the principle of retroactive taxation running back 6 months we also assert the right to carry it back for 1 year or 10 years, or for any length of time. To do this would hold out a threat of uncertainty in tax conditions, and almost the greatest foe of business productivity and prosperity is uncertainty. For these reasons the committee had no doubt as to the wisdom of striking from the bill the retroactive tax on incomes. * * *" (S. Rept. No. 103, 65th Cong., 1st sess.)

An obvious oversight in the Revenue Act of 1942 had enabled public utility companies to reduce excess profits taxes by payments of dividends on preferred stocks, and certain companies had taken advantage of the oversight. In 1943 a proposal that the Revenue Act of 1943 should remedy the oversight was rejected in the Senate on the grounds of retroactivity. (See Congressional Record, January 12, 1944, pp. 109 to 111.)

The most recent instance of forbearance by the Congress occurred in 1950. Due to the operation of the formula for taxation of life-insurance companies contained in the tax law prior to the Revenue Act of 1950, life-insurance companies

paid relatively small income taxes from 1947 to 1949, inclusive. In October 1949, 2½ months before the end of the calendar year 1949, and 5 months before the due date for filing 1949 returns, House Joint Resolution 371 was introduced to correct the formula and thereby increase taxes for 1947, 1948, and 1949. As finally embodied in the Revenue Act of 1950, the revision was made applicable only for 1949, the year in which life-insurance companies were put on notice that Congress might amend the formula. The following comments of the Committee on Finance of the Senate succinctly summarized the legislative opposition at that time to retroactive taxation:

"Your committee does not believe it advisable to apply the formula retroactively to the years 1947 and 1948. The returns for those years were filed some time ago; the books of the companies have been closed; and in some cases no reserves were established to cover the Federal tax liability. Testimony before your committee in its hearings on House Joint Resolution 371 disclosed that some companies had made commitments in those years relying on the fact that no Federal income tax was payable under existing law. Hence, the payment of a tax now would impose a hardship upon the policyholders.

"The committee believes that the constitutionality of a tax imposed at this time on 1947 and 1948 incomes is at least debatable. It is evident that some companies will contest the validity of such a tax and others may be forced to do so through action of their policyholders.

"Even if your committee were of the opinion that a tax levied now on 1947 and 1948 incomes would be upheld by the Supreme Court, it would still oppose retroactive taxation extending over such a long period of time. The imposition of a tax on 1947 and 1948 incomes at this late date would be inconsistent with fundamental public policy which requires that a taxpayer's obligation to his Government be made definite and certain at the time the tax is due.

"In attempting to justify the 1947 and 1948 taxes the House report stresses the history of the preliminary negotiations between the Treasury Department and the representatives of the two associations of life-insurance companies, which have been in process ever since the autumn of 1947. However, your committee does not regard the existence of these negotiations as putting the insurance companies on notice that the Congress might adopt retroactive legislation extending as far back as 1947 and 1948. In fact some of the witnesses before your committee testified that they had no notice that such retroactive legislation was contemplated, even by the Treasury Department, until August 1949.

"On the other hand, the life-insurance companies have been on notice that a revision of the formula was being considered by the Congress for the year 1949, at least since October 10, 1949, the date House Joint Resolution 371 was introduced. This date is over 2½ months before the end of the calendar year 1949 and 5 months before the due date for filing 1949 returns" (S. Rept. No. 2375, 81st Cong. 2d sess., p. 39).

Taxpayers did not receive notice of possible repeal of section 462, Internal Revenue Code 1954, until February 1955, approximately 2 months after the close of calendar year 1954. On the basis of the foregoing, it is clear that a current retroactive repeal of section 462 of the Internal Revenue Code of 1954 would produce lengthy constitutional litigation which would in all probability result in the invalidation of the repeal, and consequently a failure to accomplish the purposes now desired by its proponents.

2. The retroactive repeal of section 462 of the Internal Revenue Code of 1954 would be grossly unfair to taxpayers who, relying upon the provisions of the code of 1954, including section 462, have already determined their income after Federal income taxes, and made business or personal commitments on the basis thereof.

It would be superfluous here to enumerate the various ways in which taxpayers have relied upon the provisions of the 1954 code, including section 462 thereof. Numerous taxpayers have made business or personal commitments based upon their net income after Federal taxes computed under the 1954 code. Reports to the shareholders and creditors have been issued on the basis of the tax law enacted in August of 1954. Similarly, dividends have been paid in reliance upon the 1954 tax statute. It is beyond doubt that gross inequity and commercial instability would result from retroactive repeal of section 462.

Inequity similar to that which would result from the retroactive repeal of section 462 has been recognized in the past by the Congress as a basis for rejecting such legislation. As noted above, in 1917 the 65th Congress refused to levy an additional tax on 1916 incomes. The report of the Senate Finance Committee in this regard stated as follows:

"This tax seemed to the committee to be in principle both morally and economically unsound and to deserve exclusion as retroactive legislation. The incomes of the past calendar year have paid their taxes, and the balance has either been spent upon subsistence and the expenses of living or it has been saved and added to capital, in which form it will yield returns which will bear taxes in the ensuing years. To tax this taxpaid income again is not only double taxation of a peculiarly obnoxious kind, but would possibly compel the taxpayer to impair his capital by paying this second tax and thus diminish the Government's sources of taxation. This tax, if persisted in, would fall upon money already distributed and would interfere with contracts already made. It would, in a word, be one of those disturbing taxes which would alarm business and check industrial productivity, to which we must look as our chief source of taxation. It is very poor economy to take money in a way which will cause losses far outweighing the monetary gain."

III. Recommendation: Section 462, Internal Revenue Code of 1954, should be retained for calendar year 1954 and for initial fiscal years beginning after December 31, 1953, and ending after August 16, 1954. Section 462 should be amended to provide that for later taxable years reserves will be allowed only for specific items of expense, principally those enumerated in the reports of the Senate Finance Committee and of the Committee on Ways and Means accompanying H. R. 8300 of the 83d Congress, 2d session.

In light of the strong constitutional and equitable objections to the retroactive repeal of section 462, it is respectfully recommended that the section be retained in its present form for calendar year 1954 and for initial fiscal years beginning after December 31, 1953, and ending after August 16, 1954.

The proponents of repeal of section 462 do not challenge the desirability of preserving similarity between tax and financial accounting methods. The principal objection to section 462 in the form passed in 1954 is that the provision is too broad in scope, and, consequently, permits the deduction of additions to reserves for estimated expenses that were not within the original legislative intent. The section should be amended for 1955 and later years by limiting its applicability to specific items. In main, reserves should be allowed for those expenses enumerated in the reports of the Senate Finance Committee and of the Committee on Ways and Means accompanying H. R. 8300, such as returns and allowances, freight allowances, quantity discounts, vacation pay and liabilities for self-insured injury and damage claims (S. Rept. No. 1622, 83d Cong., 2d sess., pp. 305–307; H. Rept. No. 1337, 83d Cong., 2d sess., pp. A162–A163).

If the committee should so desire, the undersigned will be very glad to expand on these recommendations either orally or in writing.

Respectfully submitted,

THE WESTERN UNION TELEGRAPH COMPANY,
By ROBERT C. BARNETT, *Tax Attorney.*

STANDARD-JOHNSON CO., INC.,
Brooklyn 17, N. Y., May 4, 1955.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: The entire tax collection system is based on the good faith of the taxpayer. In return the taxpayer expects good faith in the administration and consistency of tax laws.

Therefore, we vigorously protest retroactive repeal of sections 452 and 462 of the Internal Revenue Code of 1954. Our company changed its accounting procedures in accordance with this code and based on these changes made certain commitments which cannot be changed retroactively.

Should the Senate Finance Committee reject the bill to repeal these sections retroactively, it will reaffirm the confidence taxpayers have in the good judgment and good faith of our law making bodies.

Very truly yours,

EDMOND J. DONNELLAN,
President.

PHILADELPHIA, PA., *May 6, 1955.*

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

SIR: I do hereby protest against the complete retroactive repeal of sections 452 and 462 of the 1954 Internal Revenue Code.

These sections were enacted to correct inequitable tax treatment of income and expenses. It is recognized that many tax practitioners and taxpayers may have abused the privileges accorded by these sections but it is believed that there is ample provision in the Internal Revenue Code permtting the Internal Revenue Service to determine the reasonable amounts which may be added to reserves and deducted in computing taxable income.

If those who advocate the repeal can conclusively demonstrate the serious loss of revenue which they claim will result from the continuance of these sections, it is suggested that the deduction for the year of changeover be limited to the amount provided in such reserve together with a proportionate part of the deduction actually sustained in the year.

Respectfully submitted.

ALBERT T. HASSELL.

MEMORANDUM RE SUGGESTED CHANGE TO H. R. 4725

On March 24, 1955 the House of Representatives passed H. R. 4725 under which sections 452 and 462 of the Internal Revenue Code of 1954 would be repealed. This bill is under consideration by the Senate Finance Committee.

Section 4 of this bill contains saving provisions. Subsection 3 of section 4, in effect, allows to taxpayers deductions from income for a particular fiscal year for payments or additional payments required to be made to other persons by reason of the repeal of such sections 452 and 462 of the Internal Revenue Code of 1954, notwithstanding such payments were not actually made or accrued during such fiscal year. The bill provides that retroactive deductions will be allowed if such payments are made on or before September 15, 1955. It is respectfully submitted that such subsection 3 should be expanded in the manner hereinafter set forth. The reasons for suggesting these changes lie in the fields of employee profit-sharing plans and charitable contributions

Under a number of qualified profit-sharing plans maintained by clients of the undersigned, the employer contributions are based upon "net income," determined in accordance with generally accepted accounting principles and practices as of some prescribed date after the end of each fiscal year. For reasons of practicality, such determination is made final and conclusive, notwithstanding any adjustments resulting from subsequent audits. By reason of the inclusion of sections 452 and 462 in the Internal Revenue Code of 1954 the employers who maintain the profit-sharing plans referred to above computed their income for the calendar year 1954 (and for fiscal years commencing after the enactment of such code) in accordance with changed accounting principles and practices, conforming to such sections of the code. In all the cases with which the undersigned is familiar, the net income of the employers was thereby reduced for all purposes, including the calculation of their profit-sharing contributions.

Several of these employers would feel a moral, if not legal, obligation to make additional contributions in respect of the calendar year 1954 (and for fiscal years commencing after the enactment of such code) under their profit-sharing plans, reflecting increases in their net income resulting from the repeal of such sections 452 and 462. However, subsection 3 of section 4 of H. R. 4725 would permit a deduction for an additional contribution only if the same is "required," and the profit-sharing plans to which reference is made do not require adjustments in contributions for adjustments made after the end of a particular fiscal year or after the end of the period prescribed in the plan for making the contribution.

It is submitted that there would exist, under H. R. 4725, in the area of charitable contributions, uncertainties and inequities. Taxpayers (either corporations, individual proprietors or partners), who have taken advantage of sections 452 and 462 of the Internal Revenue Code of 1954 and have thereby reduced their taxable income for the calendar year 1954 (or for fiscal years commencing after the enactment of such code), have thus reduced the limitations under section 170 of the Internal Revenue Code of 1954 on allowable deductions for charitable contributions, since these limitations are related to "adjusted gross income." Thus, in the event that such sections of the code are repealed by way of H. R. 4725, many

taxpayers will be required to report additional income for the calendar year 1954 (and for fiscal years commencing after the enactment of such code) without the benefit of increased deductions for charitable contributions, unless this bill is changed to permit retroactive deductions for charitable contributions made after its enactment.

Accordingly, in the suggested revision of subsection 3 of section 4 of H. R. 4725 (set forth below), provision is made for the allowance of retroactive deductions for payments (or additional payments) which would have been made except for the adoption of accounting methods conforming to section 452 or section 462 of the Internal Revenue Code of 1954, provided such payments (or additional payments) are made prior to September 15, 1955; for this purpose payments would include charitable contributions deductible under section 170 of such code. The suggested revision to subsection 3 is as follows, with changes indicated by italic:

"(3) Treatment of certain payments *and contributions* which taxpayer is required to make *or would have made*, if—

(*a*) the taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of this act, *or would have made such payment (or additional payment) except for the adoption of accounting methods conforming to section 452 or section 462 of the Internal Revenue Code of 1954*, and

(*b*) the Internal Revenue Code of 1954 prescribes a period which expires *with or* after the close of the taxable year, within which the taxpayer must make such payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then, subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, if such payment (or additional payment) is made on or before September 15, 1955, it shall be treated as having been made within the period prescribed by such code."

The undersigned respectfully asks this committee to give favorable consideration to the above in order to avoid the inequities mentioned.

Respectfully submitted.

G. BARRON MALLORY,
Member of the Bars of New York and Connecticut.

Dated New York, N. Y., April 28, 1955.

THE MILLER PUBLISHING CO.,
Minneapolis, Minn., April 26, 1955.

The Honorable EDWARD J. THYE,
United States Senate, Washington, D. C.

MY DEAR SENATOR THYE: I got the impression from reading the House debate on the bill repealing retroactively sections 452 and 462 of the 1954 Internal Revenue Code that those who voted for the measure did so under the fantastic impression that not to pass it would bankrupt the United States Government. There was some recognition of the fact that these sections embodied good accounting procedures and represented an important and proper service to business enterprises whose accounting procedures permitted them, under the code sections in question, to take tax benefits for prepaid income (notably for magazine subscriptions) and for estimated expenses, but the voices of those who were bold enough to take this position were drowned by the cries of those who anticipated billions of dollars of lost tax revenue and who described the sections as loopholes through which that great implied "malefactor," business enterprise, was escaping its tax obligations. A survey of taxpayer returns, made by the American Institute of Accountants, describes the so-called anticipated loss in terms of millions instead of billions.

I grow very weary of all this congressional palaver about loopholes and tax losses, implying that any money remaining in the tills of private enterprise after the tax collector has come around ought really to be in the Federal Treasury, and that for it to be anywhere else is sinful.

Repeal of the sections in question, it seems to us, would be an act of bad faith by Congress, and the repudiation of a good taxing principle which was correctly recognized in the 1954 revision. We filed our tax return on the basis of that revision and our annual report and many far-reaching decisions were based on the logical assumption that the 1954 code, including, of course, sections 452 and 462, was established tax law and not an irresponsible and shifty legislative experi-

ment subject to such second-guessing as is now being indulged in. Retroactive repeal of the sections in question would have a grave and disturbing effect on our business position and our business outlook. We do not understand why Congress should wish to penalize us so severely and inequitably by arbitrarily and retroactively taxing us on a cash accounting basis rather than the accrual basis upon which we do business. This would be the effect of the repeal. I urge you to vote against it.

Faithfully yours,

CARROLL W. MICHENER.

INLAND STEEL CO.,
Chicago, April 29, 1955.

Hon. HOMER E. CAPEHART,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR CAPEHART: I am writing this letter, not with the particular interest of our own company in mind, but on behalf of the principles involved should sections 452 and 462 of the 1954 Revenue Act be repealed.

It was my privilege to serve as chairman of one of the special groups which conducted extensive studies in contemplation of necessary revisions in the statute to remove the inequities that have long been present.

In the objections filed currently, no one has challenged the validity of the principles involved, nor has anyone questioned the fact that the inequities have existed.

The sole objective has been, and still is, that the needed changes involve revenue loss.

The Revenue Act of 1954 represents one of the most constructive achievements in tax legislation, and in removing inequities which are inconsistent with accepted sound accounting principles, it was a great step forward in fair and equitable taxation. These values should be preserved.

Because revenue loss is involved, the expedient solution can be to repeal the sections involved. In my opinion, however, it cannot be the right answer for there can never be justification for the restoration and continuance of inequities in a fair and just tax structure.

I should like to urge that the principles, as set forth in sections 452 and 462, be retained, and to the extent that revenue loss is involved, the impact should be minimized by limiting the benefits currently and, over an appropriate number of years in the future, permit an increasing allowance until the inequities shall have been fully removed.

Your serious consideration of this important matter will be greatly appreciated.

Very truly yours,

RUSSELL L. PETERS.

AMERICAN MERCHANT MARINE INSTITUTE, INC.,
Washington, D. C., May 4, 1955.

Senator HARRY FLOOD BYRD,
Chairman, Committee on Finance,
United States Senate, Washington 25, D. C.

DEAR SENATOR BYRD: The American Merchant Marine Institute represents the owners of a substantial majority of American-flag shipping of all categories, and is therefore concerned that H. R. 4725, which would repeal section 462 of the Internal Revenue Code of 1954, would reestablish a tax inequity which previously existed. The American-flag steamship industry of course favors the closing of tax "loopholes" but is compelled to record itself in opposition to H. R. 4725 in its present form unless appropriate provision is made for the establishment of reserves to meet certain claims incurred during a current year but not payable until subsequent years.

Section 462 of the Internal Revenue Code of 1954, which would be repealed in its entirety by this bill, corrected a tax inequity which had existed prior to the 1954 revision of the code, and which was peculiarly prejudicial to the transportation industry. It is a long-established accounting practice in the steamship industry to charge against the current year's income uninsured liabilities incurred for damage to cargo, or for injuries to crew or other persons arising during the current period, some of which are not paid until subsequent years. This practice has been not only recognized as necessary by interested Government agencies, but is, in fact, required to be followed in all dealings with Government agencies, except with respect to income taxes.

We submit, therefore, that any revision of the Internal Revenue Code of 1954 should provide for the deduction as a business expense of reserves set up against claims or similar liabilities incurred in the taxable year. Such a provision is necessary in order to eliminate the inequity that applied to American steamship lines prior to the Internal Revenue Code of 1954.

This letter has been discussed with American Tramp Shipowners Association, Committee of American Steamship Lines, and Pacific American Steamship Association, and states the views of those organizations as well as of the Institute. We respectfully request that this letter be incorporated in the record of your hearings on H. R. 4725.

Sincerely yours,

HERBERT R. O'CONOR.

TEXTILE WORKERS UNION OF AMERICA,
New York, N. Y., March 31, 1955.

Senator HARRY FLOOD BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: In contemplating the effects of section 462, the following data, obtained from the published financial reports of 12 textile corporations, may be of value. Please enter these data in the record of any hearings. We shall gladly furnish you with additional data as these reports are received.

Very truly yours,

SOLOMON BARKIN.

TEXTILE WORKERS UNION OF AMERICA, RESEARCH DEPARTMENT,
NEW YORK, N. Y.

Textile companies which have utilized estimated expense provision (Sec. 462) of the Internal Revenue Code of 1954

Company	Year ended	Net sales	Profits		Estimated expense deduction	Tax saving
			Before taxes before estimated expense	After taxes [1]		
Adams-Millis Corp.	Dec. 31, 1954	13,563	755	310	83	43
Allen Industries, Inc.	do	34,103	2,702	1,283	58	[2] 65
American Manufacturing Co.	do	10,224	788	763	25	25
Belding Heminway Co., Inc.	do	21,538	893	461	[2] 56	29
Bemis Bro. Bag Co.	do	115,836	[3] 3,657	[3] 2,298	659	343
Botany Mills, Inc.	do	22,869	[4] 4,167	[4] 4,304	137	(5)
Cannon Mills Co.	do	180,130	20,559	9,793	[2] 730	[2] 380
Cone Mills Corp.	do	140,679	6,359	2,624	794	415
Dan River Mills, Inc.	Jan. 1, 1955	81,776	5,236	2,840	[2] 5	[2] 3
Felters Co.	Dec. 31, 1954	8,781	457	202	[2] 44	23
Johnson & Johnson	do	200,926	21,737	9,763	1,600	832
Munsingwear, Inc.	do	27,555	1,464	645	210	109
Vanity Fair Mills, Inc.	do	20,237	2,806	1,409	83	[2] 43
Total		878,217	63,246	28,057	4,484	2,310

[1] Represents results as reported by companies, i. e., after deduction of estimated expense and after tax saving.
[2] Estimated.
[3] Before loss of $963,000 on liquidation of Strongwall Mills, Inc., a nonoperating charge.
[4] Loss.
[5] No immediate tax benefit, but the provision increases the amount of loss, which can be carried forward to offset future profits. (This would mean a tax saving in the future.)

ELECTRIC SORTING MACHINE CO.,
Grand Rapids, Mich., April 8, 1955.

Hon. CHARLES E. POTTER,
United States Senate,
Capitol Building, Washington, D. C.

MY DEAR SENATOR: In our recent conversation we expressed a desire to summarize our thoughts on code 452 of the 1954 tax law for presentation and insertion in the Senate Finance Committee hearings.

Mr. J. S. Seidman, general chairman, American Institute of Accountants, recently wrote the following:

"I notice that in the debate on H. R. 4725, regarding the repeal of sections 452 and 462 of the 1954 tax law, consideration was given to the retention of section 452, dealing with prepaid income, but it was concluded that both sections must go.

"Two reasons were assigned for this. The first reason was that if the prepaid income section were retained it would be possible to bring about the same result under that section as is now obtained under section 462 by a change in form of the transaction. I wonder whether this stands up on practical analysis.

"Under section 462 the two major categories are vacation pay and product guaranties. Vacation pay can't possibly become prepaid income since the taxpayer is only on the paying side, whereas prepaid income requires receipt by the taxpayer.

"On product guaranties, in order to have prepaid income the situation would have to be such, under the proposed regulations, that the guaranty is a separate transaction from the sale, entered into at the option of the purchaser. In other words, there are two people to be dealt with, the seller and the buyer. The seller is the taxpayer. The customer is the one whose option would control. Under such circumstances, it is hardly realistic to say that a change in form is all that would be involved.

"Furthermore, even if product guaranties could be cast as prepaid income the results would not be the same as under section 462. Under that section the deductions to make good on the guaranty would be taken in the year of sale, whereas with section 452 alone, the deductions would be taken only as the expenditures to make good on the guaranty are incurred. The only effect of section 452 would be to space the advance collection of the guaranty money over the period to which it applies in the reporting of income, just like the advance collection of 5 years' rent.

"The second reason assigned in the debates as the need for eliminating section 452 was covered by an illustration where there was an advance collection of $1,000 for 5 years' rent. The following explanation is made: 'Under section 452 this rent could be spread over a period of 5 years and, there, the company would only have to report $200 rent for each of the 5 years commencing with 1954. If the commissions and expenses of negotiating the lease amounted to $200, all of this expense could be applied under this section against the $200 rent reported in 1954 and thus eliminate the rental income for that year. This result might have a serious effect upon the revenue.'

"I am afraid that the quoted stated on which the conclusion depends is not sound. The commissions and expenses of negotiating a 5-year lease are not deductible all at once. Their deduction is limited to a pro rata part each year over the life of the lease. In other words, instead of $200 of commissions and negotiation costs being deductible immediately, only $40 would be deductible in each of the 5 years. That is the very situation that points up the irony of the old law. The $1,000 rent collected for the 5 years is reported immediately, whereas all of the expenses incurred in connection with getting the lease and the $1,000 are deductible only pro rata over the 5 years. There is no matching of income and expenses.

"As you know, the institute is in hopes that the Congress will see fit to retain both sections 452 and 462, with the modifications and restraints that we recommended. It does seem to us that, in any event, section 452 should be preserved, and that the reasons assigned for not doing so, merit reexamination."

We will sincerely appreciate your representing us in this matter.

Very truly yours,

JOHN E. VENEKLASEN,
Vice President.

TAYLOR TRUSTS,
Phoenix, Ariz., April 13, 1955.

Hon. Senator CARL HAYDEN,
United States Senate, Washington 25, D. C.

DEAR SENATOR HAYDEN: In 1951 Mr. and Mrs. Keith Taylor created 4 separate trusts for their 4 minor children under 1 trust indenture, which they designated as No. P–1162. Both of the undersigned are the two cotrustees for these irrevocable trusts, the principal assets of which are certain warehouse buildings which they own in Phoenix and Glendale, Ariz. For the past several years we have been operating under contracts with the Commodity Credit Corporation and have been storing governmentally owned commodities for their account.

Late last summer the Commodity Credit sold all of the cottonseed meal in our custody, or approximately 25,000 tons. It was the Government's obligation under that sale to pay the outhandling charge of $1.50 per ton either at the time the commodity was actually outhandled or on the last date for which they assumed responsibility for payment of the storage itself, namely, August 31, 1954.

In checking with the purchaser of this meal, Western Cotton Products Co., we found that they had no definite plans as to when this meal would be moved. However, it appeared that the bulk of the outhandling would be performed during that same calendar year. The matter of the collection of the outhandling allowance was discussed with proper tax counsel and they informed us that under the Revenue Act of 1954 that we would be entitled to collect all of the outhandling allowance and for any portion of the cottonseed meal that still remained in our warehouses on January 31, 1955 (our fiscal year-end), that we could establish reserves at the rate of $1.50 per ton for tax purposes until such obligation had been fully discharged. These facts have definitely been ascertained to the best of our ability, we elected to collect from Commodity Credit all of the outhandling allowance.

On January 31, 1955, all of this meal was still in our possession. Accordingly we established a reserve for tax purposes in an approximate amount of $37,500 and have filed our tax return accordingly. However, we now learn that sections 452 and 462 of the 1954 Tax Code are in process of being changed on a retroactive basis, thereby creating the very grave possibility of our being compelled to file an amended return by including the $37,500 as income for the period ending January 31, 1955. If this becomes necessary, we will find ourselves in the unhappy position of paying on a net income basis the moneys received to perform certain definite services without having the benefit of charging the actual costs for the performance of such services against it. If this does become necessary, we will probably be penalized about $12,000 additional taxes for last year.

It is not our intent to protest changing of the law. However, we do feel that as cotrustees our responsibilities in that fiduciary capacity is greater than it would be if we were administering our own funds or business, and we are fearful that someone would sometime criticize our activities, although they were made with the best of intent and after such inquiries as any prudent person might make. Under the circumstances, we are protesting the retroactive feature of the proposal now before the Senate, and are asking that you support any modifications thereof which might be necessary to preclude any injustice or hardship from happening.

Looking forward with interest to your response, we are,

Sincerely yours,

TAYLOR TRUSTS,
WESTERN FARM MANAGEMENT CO.,
Cotrustee.

By M. W. AKIN, *President.*
C. B. HOOPER, *Cotrustee.*

F. W. WILLIAMS STATE AGENCY,
Meridian, Miss., April 21, 1955.

Re H. R. 4725.

HON. HARRY FLOOD BYRD,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Section 452 of the Internal Revenue Code of 1954 offers an opportunity to bring income-tax reporting into conformity with sound accounting principles in the cases of many taxpayers who, as do we, receive payments in 1 year for services to be performed and expenses to be incurred in later years. We are profoundly disturbed at the prospect of repeal of section 452, and are addressing this letter to each of the members of the Senate Committee on Finance in order to acquaint them with the problems of taxpayers in a situation such as ours.

This firm, a partnership composed of nine men residing in Meridian and Jackson, Miss., is general agent of United States Fidelity and Guaranty Co. for the State of Mississippi. This firm contracts with local agents to sell the insurance, supervises those agents, accepts risks and issues policies for the company, and performs substantially all the functions of the company throughout the terms of those policies. A substantial number of the policies are written for terms longer than 1 year.

Our income is a percentage of the premiums paid by policyholders; if there is a return of the premium on account of cancellation or other reason, we have to give back this firm's percentage thereof. As will be discussed hereinafter, only a part of the cost of a general agency is incurred when an insurance policy is issued; substantial expenses are incurred over the entire life of the policy.

Under case law and administrative rulings prior to the enactment of section 452, the policy commissions had to be included in taxable income of the period in which the policies were issued or the commissions received; the expenses were deductible from income when incurred over the entire life of each policy. As is clearly recognized in all published discussions of the subject by accounting authorities, this treatment does violence to the basic principles of accounting for income.

Let us consider first the fundamental premise upon which the determination of income should be based, that of relating the cost of producing income to the income produced - colloquially, matching income and the corresponding expenses of producing that income.

When an insurance policy is written, the agency incurs only a part of its total expenses with respect to that policy. Those initial costs include the sales cost and the underwriting cost of reviewing the risk and issuing the policy contract.

Immediately thereafter being additional costs, material in relation to total costs in discharging the obligation of the agency to service the policy during its term. Such service continues throughout the existence of the policy contract, and is just as much a part of the consideration for which the commission is paid to the general agent as is the acquisition of the business in the first instance.

Illustrative of these services are:

1. Inspection of physical premises of insured at intervals during term of policy.
2. Calls on insured, upon request, to discuss the coverage of his policy.
3. Reviews of coverage reports and periodic recalculation and adjustment of premiums.
4. Loss reports are sent to general agent for review and recommendation.
5. Loss payment information is recorded and statistical analyses prepared. Studies of these reports are made, conferences held, etc.
6. In this particular case the handling of fire and inland marine claims for loss is done by the general agent except that the investigation of loss is assigned to a general adjustment bureau. The agency receives notice of loss, makes investigation assignment to general adjustment bureau, issues draft for loss, pays and receives settlements between reinsurers on losses, keeps statistics on loss reserves and loss payments, etc.

A specific illustration of how net income is distorted is offered by a fire policy written on a monthly reporting basis to cover stocks of merchandise (inventory). A study of such a case follows with income computed in accordance with income tax regulations:

A fire policy can be written for a 3-year term on a monthly reporting form basis. An advance premium is charged, estimated to be 75 percent of what the actual premium will be.

Assume the following conditions:

Total estimated premium, $800.

75 percent of total estimated premium, which becomes premium charged at inception of policy, $600.

Terms of July 1, 1950, to July 1, 1953, 3 years.

General agent's commission, 10 percent of premium.

Premium adjustments made at end of first, second, and third years. Monthly reports of values must be received from insureds. This involves setting up and maintaining a tickler system, sending forms to insureds to be filled out, sending additional notices when forms are not received, and receiving and processing reports. Estimated cost of above procedure per report, $1.

	Commission received	Expenses incurred	Net loss or income
1950			
10 percent of estimated premium of $600	$60.00		
Acquisition cost estimated to be 2 percent of premium		$16	
6 reports of values handled, at $1		6	
Total	60.00	22	$38.00
1951			
10 percent of estimated premium of $67	6.70		
12 reports of values handled, at $1		12	
1 calculation of 1st year's premium		3	
Total	6.70	15	−8.30
1952			
10 percent of estimated premium of $67	6.70		
12 reports of values handled, at $1		12	
1 calculation of 2d year's premium		3	
Total	6.70	15	−8.30
1953			
10 percent of estimated premium of $66	6.60		
6 reports of values handled, at $1		6	
1 calculation of 3d year's premium		3	
Total	6.60	9	−2.40
Grand total	80.00	61	19.00

No proration of general expenses has been made in the above illustration as this is not considered pertinent to the problem.

The above method of calculating income obviously does not equitably match costs against revenues.

It is of particular interest to observe that the insurance agents appear to be singled out for inequitable treatment of these elements of income. The insurance company is permitted, indeed required, by State law to provide reserves for the unearned portion of the premiums received by it, and determination of the taxable income of the company gives recognition to this necessary principle.

The insured, who pays both premium and commission, is required by specific case law and administrative ruling to claim a deduction for such premiums on a time-lapse basis, and even the cash basis insured cannot claim the entire premium in any one accounting period (where the policy runs for more than 1 year).

The possible economic consequences of such unreal determination of taxable income can indeed be serious. Within the range of our own experience we have seen insurance agents, even before the days of present extremely high tax rates, brought to the point of insolvency by the requirements of the contracts to return unearned commissions upon cancellation of the insurance policies, or reductions of commissions based on estimated premium by reason of changes in economic conditions. Such effect can be illustrated if the following conditions are assumed:

Premiums written 1952:	
40,000 policies, at $50 average	$2,000,000
Commission rate, at 10 percent of premiums	200,000
Cost per policy $3 times 40,000	120,000
Premiums written 1953:	
30 percent of 1952 policyholders cancelled their policies in 1953:	
12,000 policies cancelled; $30 average	360,000
Return commission rate, at 10 percent of return premiums	36,000
Cost per cancellation, $2	24,000
New policies issued in 1953:	
28,000 policies, at $50 average	1,400,000
Commission rate, at 10 percent of premiums	140,000
Cost per policy $3	84,000

Net income on this assumption will result as follows:

	1952	1953
Commissions received:		
$2,000,000 premiums at 10 percent	$200,000	
$1,400,000 premiums, at 10 percent		$140,000
$360,000 returned premiums, at 10 percent		−36,000
Net received	200,000	104,000
Expenses:		
40,000 policies, at $3	120,000	
28,000 policies, at $3		84,000
12,000 cancellations, at $2		24,000
Net income—loss	80,000	−4,000

Insurance is not a business where volume drops off solely because new orders may fail to come in. The insurance contract provides for cancellation with a return premium to the insured any time up to the expiration of the policy. Insurance is an expense which experience shows businessmen do cut when money becomes tight.

An additional problem which arises is that of presenting statements of financial position of such agencies, inasmuch as, within the range of the experience of this firm, all of the insurance agents keep their records in conformance with income tax regulations, and their financial statements make no provision for the income received but not earned; nor for the related liability, contingent at the date of the statement, to return unearned commissions upon cancellation or other termination of the policy contract, or upon reductions of estimated advance commissions due to economic changes.

It had appeared that section 452 offered relief from the distortion of income which we have described and made it possible for us to elect to take the commission income into account on a time-lapse basis. On such a basis the commission income would be spread over the life of the policy contract, corresponding to the period in which services are rendered and costs are incurred. Costs would then be, with reasonable equity, matched against the income produced by such costs.

It appears to be generally conceded that section 452 represents sound accounting principles and is fair to taxpayers. Any criticism directed toward it seems to be that it may cost some revenue or that it may open loopholes. It is our confident belief that any revenue loss in the year of transition would be small and could be further eased by spreading the transaction over a period of, say 3 years; and that in the long run there would be no ultimate revenue loss, because the change is merely one of reporting income in 1 year rather than another. And if the section, in its present form, opens up the possibility of abuses, surely the remedy is to correct the section rather than to destroy it.

It is our sincere hope that the Committee on Finance will find a way to retain the beneficial features of section 452.

Yours very truly,

F. W. WILLIAMS STATE AGENCY,
W. A. LUDLAM, *Partner.*

UNITED STATES SENATE,
March 24, 1955.

The Honorable HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR: Mr. W. L. Rothschild, president of the Yellow Cab Co. in San Francisco, has sent me the following wire:

"Urgently suggest you communicate with the Honorable Jere Cooper of Tennessee and the Honorable Senator Byrd of Virginia, requesting that no legislative action be taken without public hearings on bills introduced eliminating expense reserve deductions and prepaid income treatment. Business is expected to sustain our high standard of economy then why make it the whipping boy."

I would appreciate this being accepted as a part of the committee's files on the subject.

With warm regards, I am,
Sincerely,

THOMAS H. KUCHEL.

(Whereupon, at 3:40 p. m., the committee adjourned.)